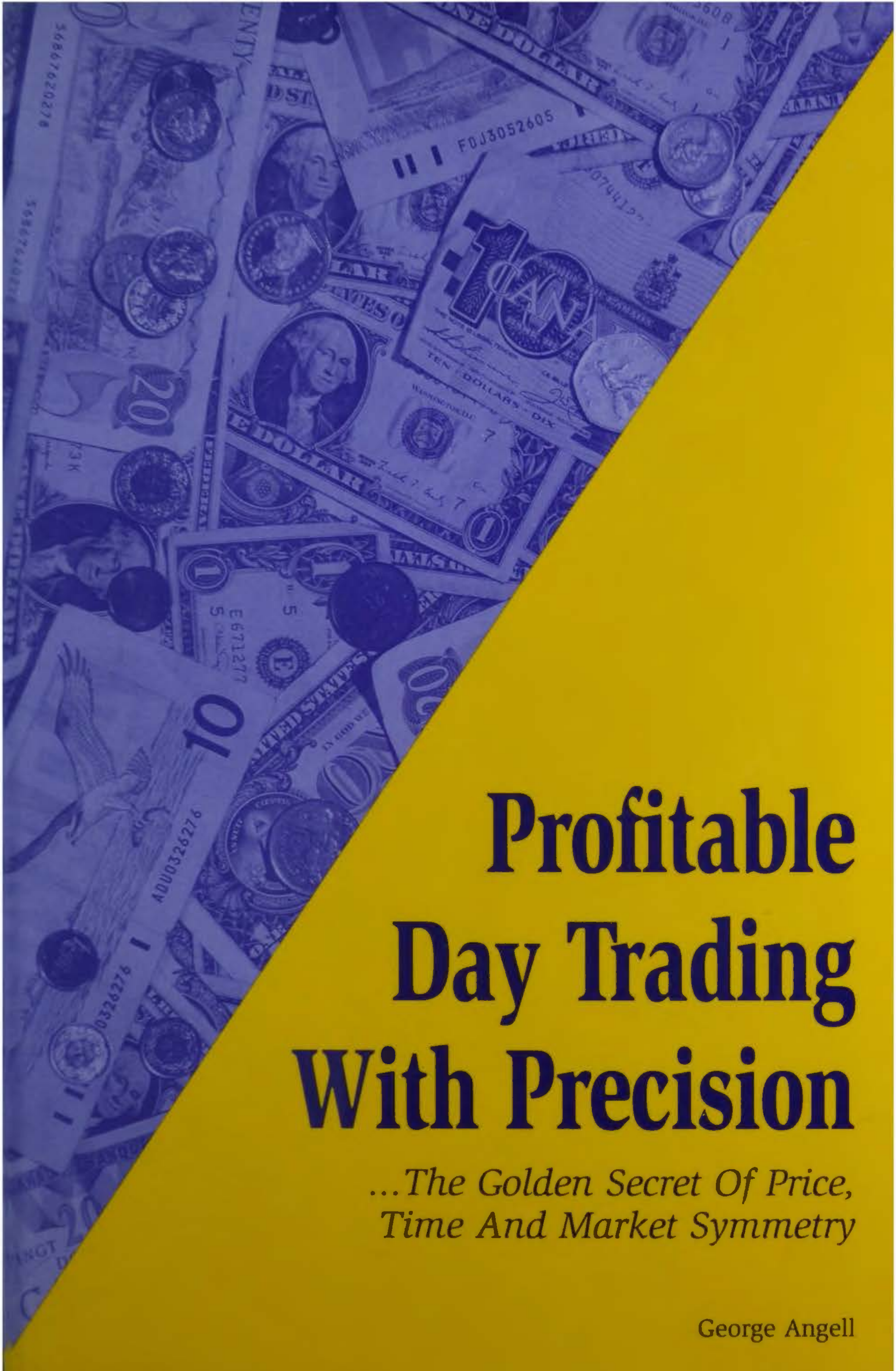

Profitable Day Trading With Precision

...The Golden Secret Of Price, Time And Market Symmetry

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TO EILEEN

ACKNOWLEDGMENTS

I'd like to thank Brad Janssen of CQG, Inc., in Glenwood Springs, Colorado, for providing me with an excellent software package. Bill Cruz, president and co-founder of Omega Research in Miami, has also been generous to me in providing excellent software for use in my trading and research activities and for permission to use TradeStation charts. Both software programs, CQG for Windows and Omega's "TradeStation," are superb examples of how technology has revolutionized the futures markets in recent years - especially in helping the smaller speculator compete on a level playing field with the larger, well-financed traders.

Programmer Duane Davis has worked with me for more than ten years now in developing and improving the LSS 3-day Cycle Method. Over the years, Duane has contributed many valuable insights into how best to day trade today's volatile markets. Lastly, I would like to thank Terry and Lisa at TradeWins Publishing. Any mistakes, omissions or errors occurring in this work, of course, are mine alone and do not reflect on any of the fine people or products mentioned above.

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FOREWORD

The first time I walked into the visitors' gallery of the Chicago Mercantile Exchange at the old Jackson Boulevard address, I thought I'd died and gone to heaven. As the elevator doors parted, I found myself looking out upon the sheer pandemonium of the trading floor. The traders themselves were completely oblivious to anything but their counterparts, who were themselves engaged in some highly-structured, yet unknowable, dance that required jumping, shouting, thrusting their arms in the air. Yet, amid the bedlam, there was a studied air of indifference and outright boredom among the ranks of clerks who seemed to perform mechanically. The contrast seemed startling. Whereas the pit traders strained, shoved, and gesticulated wildly, the clerks read newspapers, did crossword puzzles, or flirted with one another. What was this drama all about? As I pressed my head against the bulletproof glass, viewing the changing numbers on the electronic price boards that circled the walls, I sensed the nearly palpable possibilities in the air. This was the arena where fortunes were won and lost. For a futures trader, this was the center of the world.

Futures, of course, had been traded in this open-outcry method in Chicago since 1848. The manner of trading was nothing new. This is how grain futures contracts had changed hands for well over 125 years. Yet, on the horizon, with the introduction of the S&P 500 contract still in the offing, there

was a revolutionary change about to sweep the Chicago trading pits, the futures industry, and public speculators alike. Trading had always been an intensive one-on-one activity, especially on the floor. Yet, with the introduction of the personal computer and the technology explosion, the game was about to change forever. Not only would the market insiders lose their formidable grip on the market, but, for the first time, the market outsiders — namely, the public traders — had an opportunity, given the new technology, to compete on an equal basis.

What I didn't know at the time was what a steep and costly learning curve I had before me. It was as if I'd matriculated at Harvard and was planning to pay my tuition with an afternoon job at the campus cafeteria. Knowing this particular education required money — and lots of it — virtually every mistake would extract both an emotional and financial toll. The lessons to be learned would be all hard won. Far from being an easy challenge, trading required that one be a daredevil willing to walk a high wire plus be able to maintain a sensible and rational composure at the same time. The traders would fight like cats and dogs over every tick, every dollar. The pressure was relentless. And trading on thin margin made the enterprise all the more dicey, since one never knew when a single mistake would exhaust one's bankroll and the game would be over for good. For every story of untold riches, there were ten of ruin. In the early days after the S&P 500 futures contract was first introduced, traders would lease seats in hopes of cashing in on the new contract's popularity. After a particularly brutal session one afternoon, the Chicago Tri-

bune ran a photo of the empty pit with a trader sitting on one of the pit's steps, head in hand, crying. There were stories of the infamous "Rio" spread in which big winners who took large positions either cleaned up or, encountering serious losses, left on the next plane to Brazil. More stories of busted out traders trying to join the French Foreign Legion, of embezzlement and prison sentences — even suicides. No doubt about it, this was a tough game to beat. But what an upside! Successful trading was like having your own mine during the Gold Rush. When you were winning, you could live on adrenaline alone.

After ten trying and rewarding years in Chicago, I joined the ranks of those who had gone "upstairs" — indeed all the way to the tip of Florida, Key West. Given the technology — I'd now acquired real-time data, both TradeStation and CQG, and yet another end-of-day data source to run my LSS proprietary software — I felt closer to the market than I ever did in my Chicago days. What floor trader can run six programs simultaneously in his head and catch divergences within a second of their occurrence? With a phone link right to the trading pit, I could initiate a position within twenty or thirty seconds.

Here was my game plan. I would run all my numbers and immerse myself in the market. I mapped out a plan to trade aggressively — but selectively. I would immediately identify the trend and try to capitalize on the situation. Would there be an opening gap to fade? Failing at that, I'd be prepared to double and reverse. Would these reversal opportunities appear?

I would look for both the morning and afternoon trends. Was there a chance I would encounter a situation where the classical mirror image would appear — up in the morning followed by a corresponding decline in the afternoon? Or would the morning's downtrend be met by additional selling in the afternoon?

I would try to concentrate in a way to maximize my results. This isn't always easy when your phone rings constantly. But I would try to focus on capturing at least one of the day's trends. If a trade seemed to pan out, especially in the late afternoon, I would consider adding to the position. But if the market wasn't cooperating, I wasn't going to hang around for any serious adversity to occur.

Part of the joy and indeed part of the despair in trading is that you ultimately have no one to thank or blame for the results but yourself. Everyone has their own favorite way to approach the market, but mine involves being fundamentally alone. Over the years, I've tried trading with others, but the results are never as encouraging as when I alone am responsible for my actions. On the floor, the tendency is for traders to "talk their position". This means someone is long and he finds a million reasons why the market must go up — and, typically, he happens to see you standing there and, seeking confirmation for his ideas, he wants to talk about his position. Of course, if you are short at the time, it is the last thing you are interested in hearing about. I clearly remember one afternoon when I was long 16 bond contracts, representing $500 per tick, when the floor's greatest bore happened to walk my way. I quickly advised him that I wasn't interested in talking.

Now I don't care what you think, — I want to be left alone when I trade; there is too much money at stake to turn trading into a social event. I still remember the day back in the late eighties when a friend stopped by for a cup of coffee. As we watched the market from the coffee shop, I managed to lose $6,800 in an hour's time. Expensive coffee.

Since moving to Florida, I've gained considerable discipline in my trading. Nevertheless, despite my best efforts, I was still making mental errors — and it was costing me serious money. Just the week before I'd ridden a roller-coaster which was all-too familiar. First, the good news. I'd made over $7,500 in two days of trading. But several lapses in judgment cost me all the profits — and more. Determined to regain the proper discipline, I again won back more than half of the losses. Then I lost most of that money. After a week's efforts, I was back where I started around breakeven. Years ago, I remember my first trip to Vegas, when, upon winning back my losses in roulette, I exclaimed: "I'm even! I'm even!" The pit boss, upon hearing this, looked over and commented, "You were even when you sat down." Sometimes it seems like there are a million ways to lose and very few ways to win. You can select the wrong side of the market, in which case you are certain to lose. Or you can have the right side and get out on a minor correction — and lose. Or you can have the right side and add to the position in such a manner that one entry wins and the other loses, cutting into profits or resulting in losses. You can reverse on a good position and be wrong. You can have excellent paper profits and overstay the market, resulting in losses. You can be right on the market

but wrong on the timing. Sometimes even seconds make the difference between winning and losing. You can lose your concentration and let a momentary lapse shake you out of a good position.

When I am routinely asked why I don't take larger positions in the market, I'm reminded of how risky trading can be. The attitude that you know what you are doing pales in comparison to the losses on a bad day. Sure, you can know what you are doing; hopefully, over time, it will give you an important edge. But nothing can eliminate the risk. And that's where many would-be futures traders fail. By ignoring or minimizing the risk, they set in motion a series of events that practically guarantees their downfall even if their initial trading is successful. Knowing that playing Russian Roulette with an Uzi is potentially disastrous doesn't eliminate the risk if you decide to go ahead and play the game. All the big players who reap fortunes in the market have occasional large drawdowns. There is no exception to this rule that I am aware of.

Having said this, I need to emphasize the need to gain control over your emotions and adhere to solid trading rules. I've outlined a number of them in this book, but, among others, my rules are no positions overnight, keep losses manageable, monitor the position closely. You can ignore these rules and get away with it in the short run, but over time a failure to exert proper discipline will hurt you.

The point is, you never know for certain how a given trading day will play out. If you fade a market rally and it breaks to the upside, one of two things will happen. It will later come back and you can exit with a profit; or the breakout

may be genuine and it will never come back — and then what are you going to do?

I usually have good reasons relating to time and price for what I do in the market. Very often I am well rewarded for my efforts, but there is never a one-hundred percent certainty that anything you do is correct. In reviewing the prior week's roller-coaster trading experience I was well aware of this. On one day, I sold a rally thinking the market was trading near the high of the day. I was wrong. The market soared higher — before even I had time to think about getting out. I reacted immediately. I sold more. I knew that if this fast rally was simply a panicked short-covering rally, the market would react fast off the highs to the downside. Fortunately, I was correct and the market broke strongly and I grabbed my profits and exited. Then, in the afternoon, seeing a stampede on the stops at the highs, I sold to the panicked stop buyers and again collected my winnings. Right thinking was rewarded. But I knew I couldn't continue to be right on every trade. The market was waiting for me to make a lapse in judgment or concentration.

A day or two later I was sitting in my office looking for a spot to enter when a fellow who was working for me came in and was watching the screen. I explained that both time and price had to be right before entering the market. It was the wrong time of day. But, sensing the market was easy to beat, he insisted prices would go higher.

That may be the case, I explained, but right now is the wrong time. He kept insisting. Look, I told him, I'll buy a couple just to show you how hard it can be. I picked up the

phone and bought two contracts. Moments later, the market broke 90 points and I sold them at a loss — out $900. It couldn't have been more than five minutes. Two hours later the market was higher and he explained that I should have held onto the position. Easy for him to say. The fact is, the market fell another 200 points after I exited with the $900 loss. Did I really want to ride the market down, generating losses all the way, in hopes of it returning to the highs? No way. In my mind that is a prescription for disaster. For one, you will eventually encounter the day where it never comes back. For another, chances are the increasing pain of the mounting losses will force you to sell at the very bottom where reason will escape you and you will act on panic alone. Any one who has traded for a while knows that this is true.

Then there is the corroding effect of losses. When you lose money carelessly, you begin to doubt your ability to win profits. Even the smallest setback causes you to panic. You get shaken out of would-be winning positions because you doubt yourself. There comes a time when you have a series of losses when it proves difficult to even take a one-lot. You lose confidence in yourself.

At times like this, you have to reevaluate your actions. What did you know and when did you know it? Were you able to act on your observations? In reviewing some of my best winning trades, I was able to see that the clear-cut divergences in the four indicators I watch was like money in the bank. At market tops, you have the cash, Dow, and TICK all soaring higher — and the premium price is heading south. This is a sure sign the market is heading lower. The floor

knows it and by selling into strength they cannot hide their footprints. The premium will always decline if the cash stays strong or gains strength when selling hits. On the other side of the coin, the reverse happens at the bottoms. The cash, Dow and TICK all slide to new lows — while the premium turns upward. That's the bottom. These observations have stood me in good stead. The other big money winner is fading the run on the stops. If the floor traders can muscle the market to new highs — or new lows — chances are the market will reverse, at least momentarily, on days when there is no clear-cut trend. On days when there is a trend, however, you have to get out of the way in a hurry.

Even when you make mistakes, you can have a good day if you exert discipline. Coming off a big losing day, I was gun shy, taking fewer contracts than I should have. The stops were being run on the downside. No problem. I buy. The market shoots higher immediately. Thirty-five minutes later we are about to go into new high territory. I sell them at the market on the breakout. The top is double and I sell the forties. That momentary panic is the high of the day. Later, going into the close, I see another opportunity. The market is churning 20 minutes prior to the close in a tight bracket. The prior two days experienced sharp selloffs into the close. It looks like this is a repeat performance. In fact, it looks too easy. This is the identical pattern three days running. Nope. I won't fall for it. Knowing that sure things never work out, I buy eight cars, and wait. I then call in my MOC order to sell eight. Sure enough, there is a 100-plus-point rally in the final moments. I make almost $500 a car with no adversity. I

even got a good fill!

Often a day's trading success or failure will hinge on one action. It is a little like two evenly matched baseball teams. You have a pitching duel resulting in a no-scoring or low-scoring game. Then the pitcher walks a hitter. The next batter either hits one into the hole or through the third baseman's legs. A run scores — and that's the game. I made one mistake coming off a couple of good days and it cost me dearly. Knowing the high or low is typically registered in the early moments of the trading session, I bought a three-lot on the open as a "test the waters" strategy. What I didn't know was that an unforeseen hurricane was about to hit the market. I purchased the top, not the bottom. And when the break hit, I didn't want to join the panic. No. I was going to wait for the "bounce." Perhaps this was just a minor foray on the stops. It turned out it was more an annihilation of the longs. Even a small position can cost thousands of dollars in losses when the market runs.

A few days later, I was long and minor adversity set me scrambling to the sidelines with a small loss. In no mood to continue contributing money to the market, I started selling in earnest as soon as I got out of the longs. Then it went against me. And I sold more. Time passed. The market was churning. Finally, seeing the writing on the wall, I'd bought them all back in the nick of time just before a moon shot to the upside. I was lucky to get out with just a $2,500 loss. Another five minutes and the loss would have been $10,000. On some days, the best thing you can do is take a loss and leave. The losing streak persisted for another day. Again, I tried buying

and that didn't work. So I started selling — and again added to the position. Having overstayed the position, I had nowhere to go except to buy on the breakout — saving myself thousands by quick action. A lot of work and no money. It was time for a change. It was the final weekend of the summer. I flew north and went sailing. When I returned it was going to be different.

Looking back on this frustrating week, I can see a familiar pattern. Despite one's best efforts, the typical futures trader spends a lot of time waiting for the good days. More often, what one makes on Monday is lost on Tuesday, only to win again on Wednesday and lose on Thursday — and win big on Friday. Friday's profit, after all is said and done, is what adds to the bottom line. In studies we've done on LSS and other systems, we find that often one-hundred percent of the profits are made on less than 20 percent of the trades. The problem, of course, is that you never know when one of those big winning days is going to occur. Moreover, I find this notion that most of the money is made on relatively few trading days applies also to the time of year. Sometimes, January, June and August are big winning months and the rest of the months are evenly spread among offsetting wins and losses. You can still annualize the performance results. But you never know when your hard work is going to pay off — or when your trading will only result in frustration. Arguably, we would probably prefer a smoother equity curve. But given the market's tendency to lie dormant and then surge, the likelihood is that you are going to be making most of your serious money on about one-fifth of your trades.

When a trader begins trying to force the profits, especially when he is under-margined as so many novice traders are, he will quickly discover that the market cannot be forced. On some of those gyrating, trendless days, when my efforts only resulted in losses, I recognized that I was playing a losing game. When you lose and double and reverse and again lose, you are asking for trouble if you keep chasing the trend. I've had days when chasing the first $500 loss ended up a $10,000 loser, so I try to get out of the game as inexpensively as possible and wait for another opportunity. I learned this from experience. Any good systems trader knows that wins and losses are cyclical in nature. So the idea is to cut back when losing and go for it when you are winning.

In the futures market, the unexpected is more apt to be a likelihood than a remote possibility. That's why you must learn to "accept" whatever happens and move on. In short, the implausible scenario is a distinct possibility, if not inevitability. In learning to beat the market, the nature of the game changes from day to day. On Monday you can fade the breaks and make money; try that on Tuesday and you will be killed. That's why the flexible approach works. Knowing when to be cautious and when to be bold is important. In whipsawing markets, perhaps the best rule is to be adequately margined and then commit only a small portion of your bankroll to any trade. Having accomplished this, you can then think about the trade — not the money.

In the course of holding one-on-one, intensive training sessions in my trading gallery here in Florida, I've grown used to hearing the stories of how one's trading would have

been successful except for . . . you fill in the blank. On the one hand, trading is quite simple; on the other, it is difficult beyond belief. For example, my theory in a nutshell. There are two opportunities a day, one in the morning and one in the afternoon. This morning's rally was just 35 minutes in duration from top to bottom. Yesterday's break was 25 minutes. The best opportunities occur in the first hour and the final hour. Today's low of the day was registered five minutes after the opening; yesterday's final break occurred 35 minutes prior to the close. Moreover, these are not mere observations on my part. Our statistical computer research documents the evidence of these assertions. Anyone who is looking to beat the market must have available to him the best statistical evidence. This is what makes system trading so profitable. Hopefully, this book will help you capitalize on these opportunities.

I first began researching the futures market back in 1972 when I took my first trade. There wasn't much information available back then except Edwards and Magee, the authors of the bible of technical analysis. The idea was to learn some chart patterns and dive into the market. I had the bad luck to be successful almost from the start. I say "bad" because this gave me the idea that trading was easy — a common pitfall. Before I could begin a real trading career, I had the same hit-and-miss experience that befalls so many novice traders. You win money, you lose money — you throw up your hands in frustration.

In reading over the material here, I'm amazed that I've been able to survive whereas so many others were not. So

many of these observations were hard won! The double-up-and reverse strategy, finding Taylor's "Book Method" in the Merc library, learning divergence patterns, the fascinating notion of time and price - all provided a needed boost in my trading confidence. And all were learned at a high cost! Hopefully, this book will help you accelerate your own learning curve at a more reasonable rate. Good luck!

ONE

The Playing Field is Leveled

In waiting nine years, since the publication of West of Wall Street, to write this book, I wanted to make sure I had something new to contribute to the burgeoning field of trading literature. Why rehash the truisms? What I've found is that some of the most overlooked areas of the market offer the best opportunities. W. D. Gann first identified the notion of time and price. But no one, to my knowledge, has ever been able to clearly explain the workings of this mysterious strategic tool. Market symmetry exists. And, to my mind, time and price are the hidden gems that must be mined if we are to succeed at this difficult undertaking.

The organized futures markets, which, in this country, share a tradition that extends back to 1848, have not been immune to technological advances. And only in recent years have the rank-and-file speculators been able to benefit from the explosion in technology. As recently as 15 years ago, chalk boards were still in evidence at the Chicago exchanges. But in recent years, primarily due to the introduction of the personal computer and high-tech software, the playing field, where public and professional trader meet and execute trades,

has finally been leveled. No longer is the public in the dark about sudden price gyrations. Indeed, you could make the case that, due to the sophistication of communications, the floor trader is the one operating at a disadvantage since, without benefit of computer analyses, he cannot simultaneously run five or six technical studies in his head.

More and more, the trend has been for the beleaguered floor trader to want to go "upstairs." This is a common refrain since so many of his contemporaries have done just that — and more. Today, the notion of Wall Street is a 24-hour global network of shrewd buyers and sellers poised in front of computer terminals with a phone and fax as their main trading tools. The private club atmosphere of Wall Street and LaSalle Street is a thing of the past. This leveling of the playing field has completely revolutionized trading. Fortunately, thanks to the new technology, today everyone has a reasonable chance to win.

This wasn't always the case. When I started out trading futures in the early 1970s, there were precious few books on commodities — financial futures were yet to be invented — and none outlining how to trade. By 1980, when I traveled to Chicago to try my hand at floor trading, I quickly recognized that a virtual handful of professionals were making the lion's share of the profits day after day. The same people, day after day, would routinely sell market tops and buy market bottoms. How, I often wondered, did they know when to buy and sell? Whatever they were using, they had the key to beating the market. As an outsider, who, despite my best intentions, was steadily contributing to their sizable fortunes, I

wanted to learn their secrets in the worst possible way. With the passage of time, this urge to learn and fashion myself into a winning futures trader became a passion. I was either going to learn the secrets of trading and apply them in the market or I was going to have to pack my bags and leave town.

At the time, the Chicago Mercantile Exchange was located on Jackson Boulevard in Chicago. I began to spend afternoons — and sometimes mornings — in the Merc library, reading everything I could on trading techniques. Amid the mountains of statistics and dry and arcane strategies, I began to gleam what, on the surface, appeared quite ordinary. Namely, the key to a market's daily performance — that is, how the day will progress — is inherent in the "hidden" signals that are typically present in the early trading minutes. The key was knowing how to "read" these hidden signals.

At first, I thought I had stumbled into a conspiracy where nothing could be taken at face value. For example, George Douglass Taylor's "Book Method" introduced me to the concept of market "engineering." Market forces, according to Taylor, operated in such a fashion as to fool the largest number of people as possible.

This meant the market would be "taken down" in the early going in order to "engineer" a buying opportunity at low prices for the market insiders who were happy to sell their contracts later in the afternoon at higher prices. The reverse, of course, also applied: rising markets gave rise to selling opportunities. You mean up is down? And down is up? This was my first introduction to market perversity. Simply turn whatever

you are looking at 180 degrees, and you will have a better handle on things.

I began to observe what happened when the market created a gap on the open. The higher opening gaps might be met with an initial flurry of buy orders generated by stops that the order-fillers held in their hands. But soon after the floor locals sold heavily into the public buying, the market would promptly plummet and they would be jumping all over themselves covering their short positions at lower prices. The reverse was likewise a common phenomenon. Opening gaps to the downside were an invitation to the floor to buy everything in sight — just as the public had their overnight sell orders executed in a flurry of panic selling. The smart money was always on the right side. No wonder these guys, most of whom were still in their twenties, were already rich.

THE "PERVERSITY THEORY"

I coined this phenomenon the "perversity theory" because the market seemed determined to hint at one direction and then go in the opposite. But there were other subtleties that began to capture my attention. By taking into account the kind of day the market hinted at in the early going, one could better surmise what the price action meant — and take appropriate action. I would ask myself, "Is this rally the real thing? Or is the market simply being driven up by panicky short-sellers?" It wasn't long before I could identify one from the other by market action. A short-cover rally was one of

those panicky affairs where the whole pit began buying at once. The panic buying would soon cease and a sort of "deadness" would occur at the top. Then, after a beat when the news would suddenly sink in, all hell would break loose as the sellers, sensing an opportunity, would shove the contracts down the buyers throats. In a word, it wasn't sustained. The perversity theory held. This common market phenomenon I call price rejection. It is one of the best signals you can follow in pinpointing market turning points.

Compare this "fake" rally with the real thing and you are talking about night and day. The whimsical rally was a little like log rolling. You better keep moving in the right direction -- and be able to switch quickly — or you're going to fall off. The real rally, on the other hand, would consist of a market which would rise and plateau. It wouldn't break despite the best efforts of the sellers to push it down. Moreover, with a little insight I began to notice that the real rallies tended to occur at precise times during the trading day. The key was time. W.D. Gann was right.

It wasn't long before I realized that a conspiracy wasn't the probable cause of this market behavior. Only that emotion, pure and simple, was the motivating factor behind market behavior. Once the emotion of fear — the fear of losing one's money — began to predominate in the market, the conclusion was inevitable. People would butcher themselves in order to get out at any price — for fear of a worse disaster occurring. In an offhanded way, a floor trader once explained to me, "It's just intimidation, that's all." Fear makes us all cowards.

You take this understandable human behavior and add in a little old-fashioned stupidity and you have a viable scenario of market behavior. The vast majority of speculators, many of whom don't know how the game is played, will be taken to the cleaners by the knowledgeable insiders who know exactly what is going on. This is not rocket science. Take the morning "running of the stops." Since many traders hold positions overnight, it is no secret where the stop-loss orders will exist — above and below the market.

So guess where the market often goes on each morning's open? And guess who adds fuel to the fire? That's right. The unsuspecting public who felt it was doing the proper thing by placing stops in the most obvious of places. Is there anything illegal about gunning the stops? Not at all. After all, no one holds a gun to your head and tells you to place a stop.

As I began to discern patterns in the market, I began to track the players who knew how to exploit these patterns. Taken from a micro-view, the players with the most unyielding mind-set were the scalpers. Their approach was simple. Buy breaks, sell rallies. Given lightning speed and a thick head coupled with sheer aggressiveness, scalpers profited handsomely on days when the market refused to trend.

"Buy low!" became the scalper's refrain, "sell high!" It was clear they'd had this simple notion drummed in their head in the school of hard knocks down in the trading pits. Indeed, it often stood them in good stead. But I soon developed an accurate rule for measuring the kind of day we'd just had. Following the market close in the bonds, all you had to do was ride the elevators at the Chicago Board of Trade and lis-

ten to the levels of jokes and wisecracks offered by the cocky floor scalpers. On trendless days, the mirth (and profits) were considerable; on trending days, no one spoke. The old buy-low, sell-high scalping routine hadn't worked.

Then there were the trend followers. Buy strength, even new highs, in expectations of continued strength. The reverse for weakness. This worked on big trending days. But you had to know when to lay off this strategy. The market couldn't be forced. To try for a home run on a day when you could, at best, attempt to win one base on a bunt was a risky venture. Clearly, one needed to learn to couple the best strategy with the appropriate day.

The summer of 1987 comes to mind as a truly golden time in the S&P market. That summer, I was testing a new trading system that worked well in trending markets. Essentially, it made a determination as to market direction following the close of the prior day. If the New York Stock Exchange volume of rising issues outweighed those of declining issues, with a few other proprietary indicators, the market was deemed bullish and a buy position was initiated. First, one would buy the open; second, assuming a modest break, one would buy again; and, lastly, with still more market adversity, the system would take one final lunge at the buy side. Guess what? It worked almost every day. Steady to lower — and then up. Only occasionally would one have to sell the contracts at a loss either when the stop was hit or because the close was below the average purchase price. The profits were substantial and steady. What more could one ask for?

Then came the fall of 1987. And the system had to be

permanently placed on the shelf. The market had fundamentally changed. And an important lesson had been learned: the market was fluid. Not static. Survival required flexibility.

Following the October 1987 S&P debacle, I didn't go near the futures market until December — and then as a bond futures trader. The S&P market had been truly ravaged by the events of October and the safeguards that had been put in place severely hurt the liquidity. For one, margins had been set exceedingly high. While understandable, this limited the number of players, the liquidity. Moreover, the market had been sort of shell-shocked and it would take many months for it to return to its vibrant former self.

As time went on, of course, the S&P 500 futures market emerged as energetic as the days before the 1987 Crash and soared into record high territory. This is in contrast to markets which essentially die and never return. In futures trading you have to be willing to change markets and "go where the action is." The best day-trading markets are those with the largest volume and liquidity. Today, the bond and S&P markets are both excellent day-trading vehicles.

THE EMERGENCE OF TECHNOLOGY

While the investment alternatives available to futures traders are better than ever, there's been a new development in recent years that has threatened to change the game forever —technology. With the help of computers and on-line data services, the futures trader in Tokyo or London, Malibu or

Miami, has access to information the floor traders, standing in the heart of the action, can't see. I've never felt as close to the market as I do sitting in front of my 20-inch computer screen in Florida. With a phone call to the order desk, which is situated literally five or six feet from the S&P pit, I have instant access to the market. Thus, with the help of today's technology, the playing field has been leveled to an extent which was unknown even ten years ago.

The other side of the coin is that today's trader has fewer excuses. If you lose money trading because you don't know what you are doing, don't blame the floor traders. As it is, floor traders are credited with skills most of them don't possess. Most of them are ordinary folk, albeit young, who are trying to grind out a living — not the millionaire daredevils the public makes them out to be. Believe it or not, the floor traders have it tough as well. There is only so much money to go around. And, since 10 percent of the participants make 90 percent of the money, guess what the other 90 percent are doing? That's right.

Fighting like cats and dogs over the remaining 10 percent of the pie. Now, if you want to get in this game and win, you are going to have to cultivate some of the skills which the professionals use. In short, you are going to have to learn how to trade. Assuming you are starting new — or even making a fresh start if you are an experienced trader — you are going to have to accept the fact that you probably won't make any money for the next six months. In fact, if you can just break even after six months, you are well on your way to making some serious money.

Remember, the playing field is more level than ever before. There are numerous opportunities to profit — for the knowledgeable minority. But you must be the one who masters the rules and makes them a part of your trading.

NO EASY ROAD TO PROFITS

To begin your futures trading education, you must understand that there are no easy avenues to profit. The most unsuccessful traders are typically those who made easy profits when they first started trading. Why? They thought they had the game beat. In fact, they were either just lucky or totally unaware of the kind of risks they were undertaking. In either event, count yourself fortunate if you have had to struggle in the market.

Over the years, I've encountered every type of successful and unsuccessful trader you can imagine. One of my memorable introductions to the world of Chicago floor trading occurred only weeks after my arrival in Chicago when I was having coffee with a group of traders following the close of trading. The sums of money that these individuals were making seemed significant. I got the impression that if you were over the age of thirty and you hadn't yet earned a million dollars in the market, there was something wrong with you. According to their reports, ten-thousand-dollar winning days were commonplace. Some of these traders made six figures in a day! One trader even commented to me since I had newly arrived from the advisory business in California, that they,

the floor traders, were the genuine article. That, no disrespect intended, they had no use for "advisors" from California. I could hardly blame them. They, after all, traded the market. Giving advice was hardly the same thing as extracting big profits day after day. Fair enough. Understandably, I kept a low profile.

But as time wore on, I realized that everyone of this group of high-flying traders managed to go broke. After two or three years of struggling to make a living, I was still alive whereas they had all vanished, victims of their own recklessness. Ironically, the person who told me this ended up running an advisory service in, of all places, California!

Remember this if you ever think you have an easy remedy for beating the market. My approach to the market in my early days was pretty much the same as that of most new traders. You pick a direction, place a stop — and hope for the best. It sounds reasonable. But it doesn't work. I know there is something to be said for being conservative. But to hone your skills, you must aggressively pursue your opportunities and run quickly when you are wrong.

Because of the volatile nature of the futures market, a person on a limited bankroll doesn't have a lot of room to maneuver. One small loss in a day and you are licking your wounds. I don't have to do the math to show you how this can get expensive.

I was bemoaning my "bad luck" one day when a fellow trader pointed out to me that taking a loss was really nothing. You simply had to double-up and go the other way and you would have the loss back plus a nice profit on a comparable

move. For example, let's say you are trading bonds. You take a loss on, say, six ticks. When you double on the next trade, you only need three ticks to get even. Another three ticks and you are ahead of the game. He drew me a little diagram showing the only way he could lose. If the market continues to gyrate both up and down, you would be whipsawed from side to side. But given a trend in one direction — which is most of the time — your profit is assured.

Easier said than done. The first time I tried this I was scared to death. But it worked. And so I learned to "forget about the money" and began concentrating on the important thing — namely, where was the market likely to go?

When I first learned to stop worrying about the money and started thinking about what was going on in the market, I realized I'd discovered a powerful tool for success. You didn't see the big traders worried about a little adversity. After all, if they took too much "heat," they got out and forgot about the trade. The novice trader is much more apt to panic unnecessarily or, worse, wait until all is lost and only then exit the market — often, by that time, a big loser.

So the task became one of trying to analyze the market. As a day trader, I'm primarily interested in today's market and today's trend. Not what happened yesterday or last week. By taking into account the market opening and how it trades in the first five or ten minutes, I can make a reasonable judgment about the price action we are likely to encounter. After all, unlike the panelists on WALL STREET WEEK, I'm not trying to predict the Dow twelve months out. I'm trying to predict the price action for, say, 20 or 30 minutes — perhaps

an hour. What more do you need to know in order to make four or five thousand dollars a day?

Actually, in addition to a sizable margin account, you need confidence, knowledge, and old-fashioned guts to make this kind of money. I'm tempted to throw in luck as a component, because luck does play a part, but far too many traders attribute bad luck for their failure when they are really the ones to blame for their lack of success. A good trader makes his own luck. He sets himself up for winning.

I recently took an eight-lot long position in the S&P just 30 minutes prior to the close. From the moment I entered the trade, I was under water. I realized the mistake. But I quickly analyzed the situation and realized what had happened. The entry level was wrong. But the market really wasn't going anywhere. Rather than panic and take what would have been a certain $2,000 or $3,000 loss on the trade, I decided to take my chances on the close. The short-sellers were having only modest luck in driving the market lower. At the close, I reasoned, they would trip over themselves to cover, sending the market higher. I placed the MOC ("market on close") order to sell eight. Sure enough, I was able to scratch the trade and got out only paying commissions. This was the kind of "luck" that comes with experience. A less seasoned trader would have almost certainly liquidated the position at a loss only to see the market return to the entry price.

Learning to handle your money and emotions with skill and maturity is an important component to success. So often, the typical approach to the market is to make an unwise decision and then compound the problem by letting your

emotions dictate your reactions. You know the saying, "Two wrongs don't make a right." So the equation is essentially: you got in for a stupid reason and now you are getting out for a stupid reason. The result: trading losses. I'm sure you know the scenario.

Sometimes you let missed opportunities get the best of you. You see an attractive trade, you pick up the phone to call in the order, and, just as you are about to place the order, the market soars — or plummets — out of sight. Now, you are really upset and, unless you get hold of yourself, you are about to make a major mistake. For one, the temptation is to chase the market. Don't do it! Chances are, you'll only buy the top or sell the bottom. The really best trades are like hidden gems. No one knows where they are hidden — but their location will soon be known.

TWO GOOD OPPORTUNITIES A DAY

To find the best trades you have to know what to look for. With certain exceptions, there are really two good opportunities a day. Typically, these will occur in the morning, shortly after the open, and in the afternoon, most likely in the final hour of trading into the close. To me, these are like trains sitting in the station on their way to the next stop. One train is heading to a town called "Profit" and the other is headed to a town call "Loss." You want to be on the train departing for "Profit" before it leaves the station.

The early morning and late afternoon are the times when

the serious money is made in the market. This is when the trends are the purest. The idea is to jump into the market, grab the money — and leave. Otherwise, you can spend hours and hours going back and forth, generating nothing but anxiety and setting yourself up for a potential disaster which always lurks any time you hold an open position in the futures market. I'm sure there is much to be said for long-term position trading. But it doesn't interest me in the slightest. Not when I can make five or six thousand dollars a day for thirty minutes work. Why risk losing that kind of money?

The exception to getting in early is the bond market when a report is about to be released. Here you don't want to tempt fate. Chances are, the ensuing volatility will whipsaw the market in such a fashion that you will have wished you'd stayed on the sidelines. I cannot forget a call I received some years ago from a fellow bond trader who had a "novel" idea for tomorrow's report. His suggestion: we bracket the open with a buy-stop to purchase on a rally and a sell-stop to sell on a break. The report will drive the market higher or lower, he reasoned. Guess what happened? The news so upset the market that the gyrations triggered both orders within a minute and thirty seconds. The sell order was immediately triggered followed by the buy stop. Good-bye several thousand dollars.

In the afternoons, the opportunities are even greater than the morning trades because the trends are better defined. The classical pattern tends to be repeated several times a day. For instance, twenty minutes of up, down, and sideways movement following the open. Then a sustained rally. The rally

tops out and the market runs the other way — down. Typically, the real trend of the day will make itself known in the final hour. If the market wants to go down, you'll get the trend in the afternoon. But the move will often be "foreshadowed" by a sharp break in the morning or mid-day. The reverse, of course, is true in rallying markets.

In 1993, I gave a series of seminars around the country, teaching the fundamentals of sound trading. It wasn't long before I recognized that many of the seminar attendees wanted literal rules that worked without question. They wanted trading to be a science. When, in fact, it much more resembles an art form. While the guidelines I was teaching worked under many market conditions, they hardly worked all the time. The idea was to expose people to general sound trading rules. Unfortunately, they wanted certainty — the one thing the market lacked.

While this was not surprising, it gave me something to think about. If most traders yearned for certainty and if most traders are wrong, didn't it stand to reason that the most uncertain circumstances offered some of the best opportunities for profit? Moreover, it confirmed a theory I'd long held. You never seem to be able to make money on the "easy" and "certain" trades. This explained why the herd-like scalping mentality so often seemed wrong.

And who can forget the well-known adage of Humphrey Neill, the father of contrary opinion, that those who tend to think alike are all likely to be wrong? Here we have confirmation that contrary opinion works.

I began to watch the market with a different insight. If

everyone wants to buy it here, maybe it will go down. In my early years, being overly risk-adverse, I used to wait for a rally to begin before jumping in as a buyer. I can't tell you the number of times I learned that this approach doesn't work. Here, again, the same phenomenon came into play.

EVERYTHING GOES BACK TO THE MIDDLE

I was reading an article on baseball one day and an idea hit me. The writer was explaining that everything goes back to the middle. The team that goes eight or nine games undefeated, by the simple laws of probability, is due for a loss — no matter how weak the opposition. Over a season of 162 games, chances are even the best team will have its share of losers. Isn't it the same in the market? If the S&P market screams 300 points higher, isn't there a strong likelihood that profit-taking, loss-taking, or simple gravity will bring the market at least part of the way back to where it started? Of course.

What's more, I began to think in terms of trending versus non-trending days. What exactly happens on a non-trending day? For one, the market doesn't go anywhere. Oh, it may inch higher and break a bit, work lower, and close unchanged. This was the secret that kept scalpers in business. If you simply buy every break and sell every rally, chances are — at least, most of the time — you will make money. And when you compare the times when the market truly moves somewhere versus when it is relatively stable, you can see that the

percentages favor the stability play. This told me something else I needed to know. If the market truly isn't going anywhere, there is no need to panic if the market moves against you.

I use this theory to add to positions on days when my initial entry may have been premature. For instance, I buy seven S&P 500 contracts at, let's say, 749.30. On a break to 748.30, I may buy another seven. Now, my average buy price is 748.80. If I'm right and the market then begins to rally in earnest, I'm not in real trouble. On the other hand, I can watch the market closely and bail out just below 748.30 if I sense I'm in trouble.

When you make such a move, ideally the market has already traded over the early intra-day range. So you will have buyers purchasing at the support and sellers selling at the resistance. That is, you have an idea where the market should find support and resistance.

But you need to add another component to price entry selection — time. The market should move in your favor within a specific period of time or you are probably in the wrong trade. Unfortunately, one person's time framework may not be suitable for another. I find that this time period gets narrower as I get closer to the point where I have to take the loss and run. Occasionally, I must admit, my pain level kicks in right at the moment when the market is about to go my way. I can't tell you how frustrating this is, but it occurs.

Typically, my time limit is rarely more than ten minutes. I don't take a position unless I think something positive is going to happen soon. You can wait all day for an opportu-

nity to arise, but once it does, you have to jump on it immediately. At times, the period between when the opportunity becomes known and ceases to exist is measured in seconds. So count yourself lucky if you have four or five minutes to complete the analysis and take the trade. Remember, the train is about to leave the station.

TRACK THE CASH PRICE

As a rule, when trading the S&P I track the cash price closely. I find that compared to the futures price, the cash price offers all sorts of advantages. For one, the cash price is only updated once a minute; the futures, of course, can and will change from tick to tick. For another, the floor traders can play all sorts of games with the premium, or difference between the cash and futures price. If they are bearish, they can drive it to a discount; if they are bullish, the premium can go out-of-line by a hundred or more points. But sooner or later, sanity will return to the market and the cash price will dictate where the futures will go.

How do you follow the cash price? Take a price and write it down. Then give it five or ten minutes. If you are long the S&P futures, you want that cash price to rise over that period of time. Sometimes, I will use two or three time indexes. For example, I might give the cash five minutes to grow positive. If it doesn't, I may give it another five minutes. Two such negative readings and I'm thinking seriously about liquidating the futures position.

The interaction of a complex mix of indicators can also help you determine whether you have the correct side of the market. Clearly, you want the bonds to mirror the S&P futures. Bonds up, S&P's up — or vice versa. But the financial world is not so neat that this always occurs. You will have divergences in these indicators. Perhaps you should look at these as warning signs that something is wrong. In addition to the bonds, I track the numbers of advancing and declining issues on the New York Stock Exchange, the Dow Jones Industrials, the premium and S&P cash price. The TICK, which represents the number of advancing issues minus the number of declining issues, and the TICKI, which does the same for the thirty stocks in the Dow, are also important indicators that you will want to track.

With the advent of the new technology, the futures game has never been so fair nor so refined. Today, everyone with the skill to match wits with their fellow traders has the opportunity to carve out a personal profit center. But even armed with the best technology and the latest in software, you still have to master the all-important psychological challenge — which is the bane of most of those who slip on the road to trading profits.

HOW TECHNOLOGY HAS LEVELED THE PLAYING FIELD

When it comes to today's technology, public traders never had it better. The widespread availability of real-time data

puts the off-floor trader on a par with the exchange member. Indeed, one can even purchase a so-called "squawk box," on which the current bids and asks are yelled out from mid-pit. The more sophisticated software programs, moreover, take this live data and translate it into instant charts and market studies. I am fortunate in that I have two of the best software programs utilizing live data: Omega Research's "TradeStation" program and CQG's sophisticated charting program for windows. Both are excellent programs.

My CQG for Windows program enables me to access no less than 59 different studies and apply them instantly as the market is trading. Among them are: an Accumulative Swing Index, Bollinger Bands, Candlesticks, Divergence Indexes, Gann Lines, moving averages, On-balance Volume, Relative Strength, and Fast and Slow Stochastics. CQG can also run the popular Market Profile studies real-time. Omega Research's "TradeStation" program likewise runs over 100 different indicators. You will probably never need all of these studies, but it is nice to know they are all there. Significantly, the ability to access these studies as the market is trading gives the off-floor trader an edge even on the pit trader, whose primary advantage is the immediacy of the trading pit and negligible commissions. The floor trader, of course, can also see what size different players are doing. And this can be an important piece of the puzzle in deciding to take a trade.

A PICTURE IS WORTH A THOUSAND WORDS — AND MORE!

As computers have become more powerful and sophisticated in recent years, experts have turned to them for answers. In the field of futures trading, the computer is an ideal ally because it doesn't get emotional (leave that to the human trader who has emotion in abundance as he sees his money dance away before his eyes). Rather, the computer spits out the facts and the user must make his own interpretation. Since time is vital, the numbers-crunching task would go undone without the help of the computer. So here, again, the "upstairs" trader in front of the screen can see things that only a highly intuitive floor trader could sense while in the midst of the trading bedlam.

One of the strongest trading signals one can obtain in the market is that of a divergence, suggesting that price momentum is threatening to top or bottom out and a reversal is imminent. The real beauty of this signal is that it often occurs well before the actual change in price direction. But don't take my word on this. Look at the following two price charts (courtesy of Omega Research) and see whether these were sound signals. This is what I mean when I suggest the playing field has been leveled. Prior to the introduction and use of personal computers, it was impossible for the public trader to see these divergences in the market. At least, the floor trader could see the quality of the buying or selling change from strong to weak hands. But the public trader was at a disadvantage. Now, thankfully, all that has been changed.

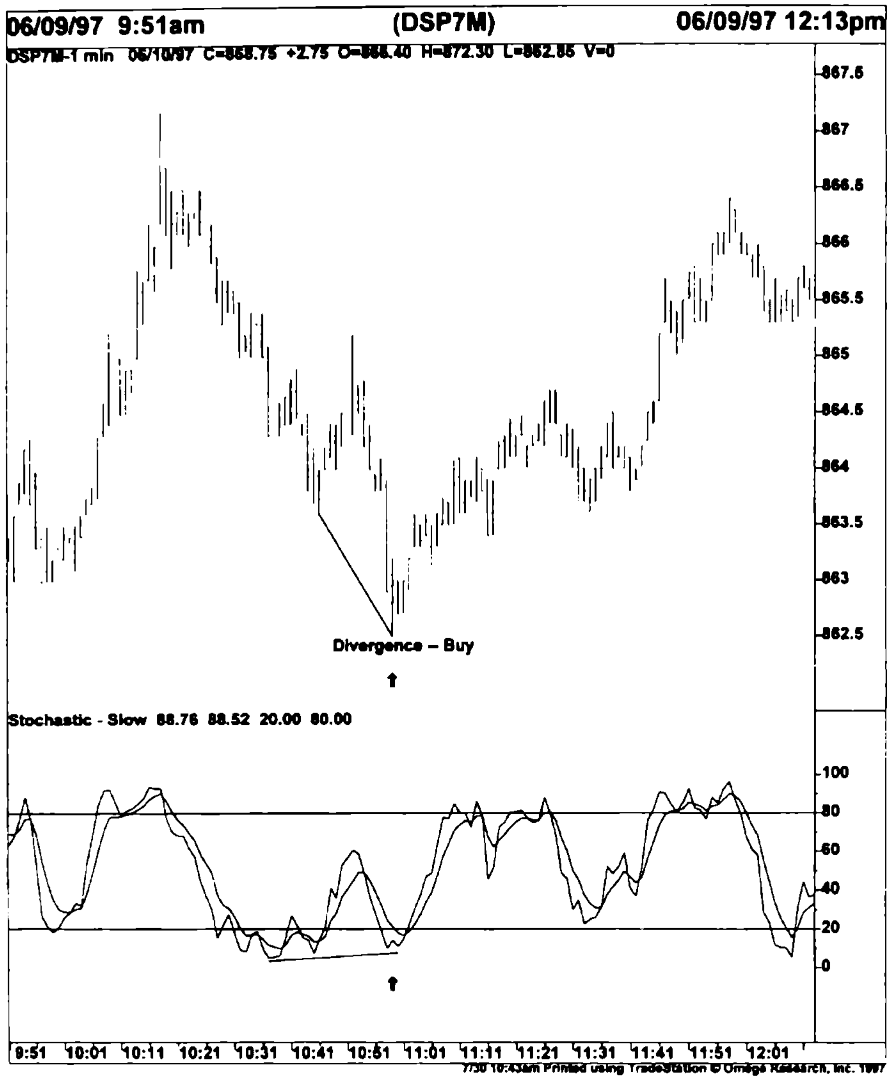


Chart #1: A divergence between price and indicator (Slow Stochastics) suggests a reversal in the market. At the top, you have the market making new highs while the Slow Stochastics cannot make new highs – the classic sell signal. At the bottom, prices are still registering new lows while the indicator is trending up – the classic buy signal.

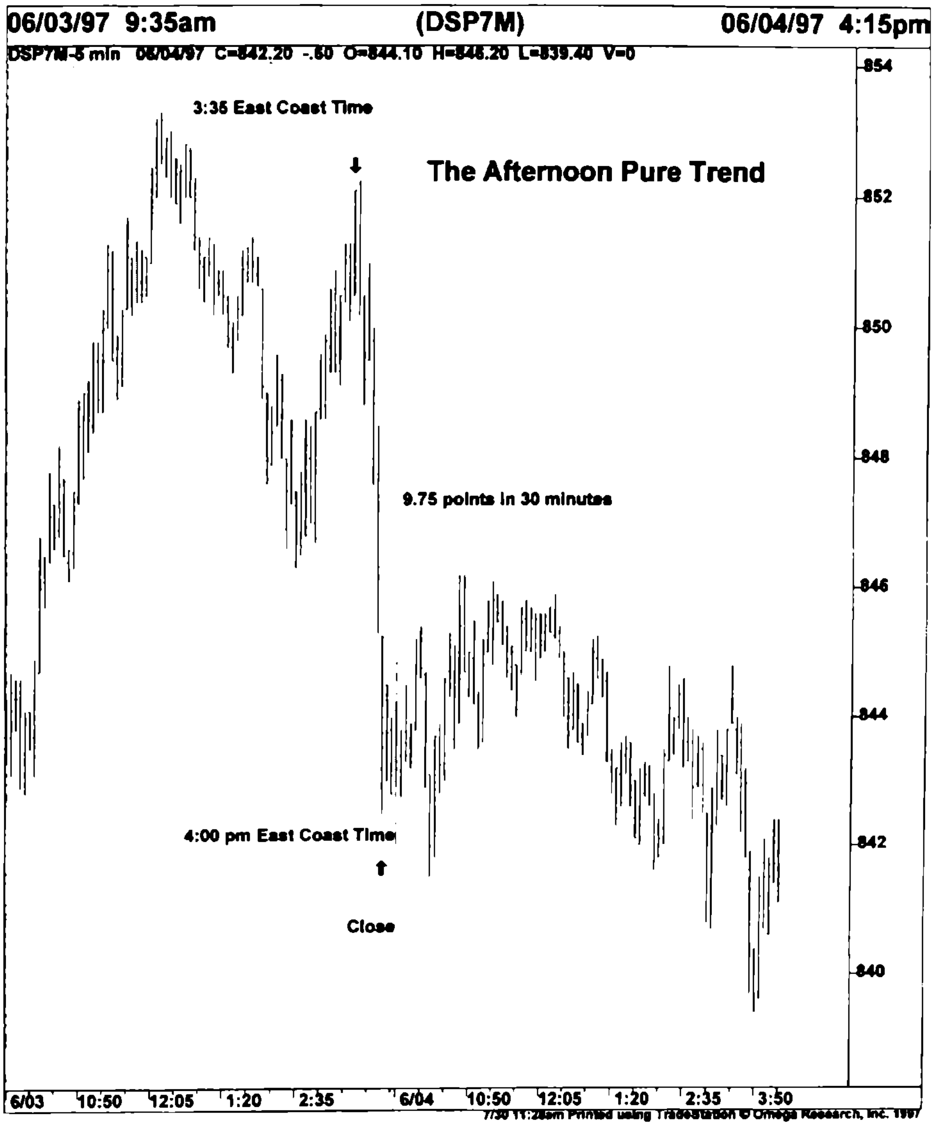


Chart #2: To set up the divergence, the Slow Stochastics line must first go into oversold ground *before* rising and then failing to go lower in the pattern of the prices. At the top, the slow Stochastics line must first rise into overbought ground *before* declining and fail to rise higher on the second attempt. If prices on the second attempt equal or rise above the previous high – while the indicator fails to match the price pattern – you have a divergence in the direction of the leading indicator.

Although I trade with the help of my proprietary LSS software trading program (see Chapter Six), I still have periods when profits elude me. When this happens, I go back to basics. Why did Thursday's successful strategy prove disastrous on Friday? Obviously, something had changed.

Students of trading systems will tell you that a long trading record is preferable to a short one. If a system has seen both bull and bear markets, chances are it will hold up on the next trading challenge. But I suspect that what has worked in recent days is the most important. If the market has been trending, for instance, doesn't it stand to reason that you can indeed buy new highs and make money?

While this may seem reasonable, chances are the trading strategy that worked last August will be a failure if employed in September. So many things might have changed over even a short month's time. The dog-days of August might have given way to the post Labor Day surge in stock prices, and that could account for all the differences.

KNOWING HOW TO TRADE IS THE KEY TO SUCCESS

For as long as the futures markets have been in existence, traders have searched for simple, straightforward methods to win. This is why so many systems exist with "proven" results. But the real question is - will they make money in the future? It is my personal opinion that, while a winning system helps, the real difference between winners and losers

involves personal judgment, knowing how to trade. How else can you account for the wide discrepancy in results among individuals using the same trading system? For years now, I've observed system users doing their best to self-destruct. Many examples come to mind. Take the individual who has a system that calls for reversing. Whereas the professional might reverse without hesitation, the novice will decide to sit back and watch for a moment — only to see the market scream in the direction of the reversal. Then there is the question of the best time to enter the market — after a series of wins or losses. The novice trader wants certainty. So he'll wait until his system wins five or six times on paper. Now he knows he has a winner. So he takes the seventh trade just as the system is entering a drawdown. If you have a winning system, the best time to begin, of course, is when the system is losing.

Sustaining losses, of course, is nothing compared with the frustration of missing a legitimate move — especially one you've been anticipating. On even a small position, such as a five-lot in the S&P, a 200-point move translates into $5,000. You only need two or three moves a month like this to generate healthy profits. But when you miss these moves, your equilibrium is shattered, and your ability to trade effectively is damaged.

It is important to be ruthless with yourself in analyzing your mistakes. I recently experienced a day when I hesitated to take a legitimate signal and the market screamed 200-points higher within minutes. Going back over the day, I can tell you that the early 30 minutes had all the hallmarks of a rising market. The pattern was familiar — lower on the open, fol-

lowed by a sharp rise and then seven or eight minutes of choppiness while a base was formed. This was a pattern I'd seen hundreds of times. With the support in place, it was clear we were having a bottoming action. All of a sudden, the indicators — TICK, TICKI, Dow, cash and advances versus declines — began to move higher in unison. The market had to be bought. But sometimes the window of opportunity is relatively short. And the move began without me. Please, please come back, I could hear myself saying. But I knew it was futile. Besides, if the move was legitimate, it wouldn't come back. Had my pleas been answered, it would have created a whole other set of problems: do I want to buy a market that promises to run but fails? Probably not. It developed that it was a classic move and my moment's hesitation cost me thousands of dollars in potential profits.

Later in the day, the market broke hard and rallied back off the lows. But the first move was the pure move, the one right after the open. That's the one I regret missing.

THE HALLMARKS OF A WINNER

Looking back, the trade had all the hallmarks of a winner. Once underway, the rally went right as I had expected. It went a good 250 points straight up before it faltered. This was the buying power running out of steam, the panicked short-sellers covering at the worst possible moment. To someone who was anticipating just such a scenario — and who had the long position — selling into the panic would have been a straight-

forward procedure. This is the best way to trade. You let the market "reach" for your sale. That way, you never for a moment take any adversity. It is pure profit from the first moment. Time elapsed from entry to exit — 25 minutes!

You have to ask yourself who's in trouble when you enter into a trade such as this. The market will clearly tell you what it wants to do by the speed with which the move is accomplished. A soaring, quick move upward signals sheer panic buying. This, in turn, triggers stops, frightens short-sellers, creates all sorts of buying enthusiasm right up to the top tick —when the whole market becomes dominated by the panic on the other side as the reverse scenario is played out. I occasionally think of days such as these when people ask me why I'm not a position trader. Can you image 300 up, 500 down, and then another 300 up again? Talk about a roller-coaster!

Soon after the missed signal, my phone started to ring. Did you get the order off? Nope. Several calls later, the response was the same. At least I wasn't alone.

It is important to recognize that even in a market where differences of opinion are the order of the day, panicked buying creates its own nightmare. If you chase the market and become a Johnny-come-lately, chances are the fill will be really bad.

As the market soared higher, it made a sudden top (they are never made slowly) and, within minutes, there was a rush to the downside, the entire rally having evaporated. I suppose this is another result of the new technology; it is no longer just the floor traders who panic. Today, everyone participates in the sheer emotionalism of the market. This adds to the price swings.

Market panic, which so often ruins one's trading day, is precisely what I'm looking for when I hold a position. This is because I know if the other side panics, my profits are assured. Just this morning, I was able to buy eight March S&P's at the bid on a decline off a rallying market. The hapless floor trader on the other side of the trade never saw a moment's profit. It just took off to the upside and hurried 150 points higher. The panic at the top was clearly caused by short-covering. Here, the shorts were paying dearly for the privilege of buying at the high of the day — anything to get out. Because of the speed of the move — the top was formed quickly — I knew the party was over. Sure enough, it came racing back down. And went negative on the day.

PATIENCE PAYS

In the weeks prior to the high-volatility markets, S&P prices had been meandering ever so higher. But the lackadaisical price moves had made the trading tough going. Day after day, my proprietary LSS method had cautioned restraint — stand aside. No trade today. With a fully funded margin account just sitting there and no opportunities to seize, I was growing restless.

Traditionally, my strategy is to throw in a couple of "soldiers" to test the waters in this kind of market. Sometimes that is all it takes to get the ball rolling. If you sell a couple and the price sinks out of sight, maybe you want to seize the first rally off the low as a genuine selling opportunity and go

for serious money. If, on the other hand, the two you sold get murdered in a rally, chances are you have the wrong side of the trade.

I can't stress how important it is to get a real feel for the market by sending out these "soldiers" into battle. I once tried this at a seminar and a man in the front row raked me over the coals for abandoning my own rules.

"Doesn't the rule on page seven say . . ." he began, and I realized he was missing the point. Trading is an art form and not a science. It doesn't lend itself to easy rules.

My only rule is buy low and sell high. How you accomplish that goal is not always easy. So I planned my strategy. Let's send in just a couple to see how they get treated. Hopefully, by then LSS will kick in and we will already have the correct side. If not, there's always time to cut losses and run with the trend.

Years ago, when I'd lived in Los Angeles, I'd taken a course in TV writing. Although I was a published magazine writer at the time, I realized that this was a specialty that clearly required mastering a difficult skill. Yet my fellow students, few of whom had any background in writing, were convinced that TV writing was simply a gimmick, something one learned in a short course. They had no idea the months and months I'd spent learning the difficult craft of writing, including the many setbacks, rejections and difficulties. In listening to them talking about the "business" — they seemed to know all about the money involved — I realized they wanted to "be" writers but weren't especially interested in doing the work required to master the field.

In the futures market, one encounters the same thing. But because so many people qualify for entry — after all, you only need a few thousand dollars and a telephone to trade — many individuals are under the impression they, too, are only a few trades away from being accomplished futures traders. One of my favorite quotes is from a seasoned floor professional in the S&P pit. "I don't do brain surgery on weekends," he told me. "What makes these guys think they can play market maker during the week?"

MANY ARE CALLED . . . FEW ARE CHOSEN

If you think that's an overly cynical statement, consider the number of athletes who aspire to professional sports and how many actually make the team. Whenever I hear people carrying on about how overpaid these athletes are, I think about the pay that any world-class entertainer earns. The pay is high but there are few who possess those skills.

In the futures markets, the "stars" make in the tens of millions of dollars. But because they don't appear on television, you don't know who these individuals are. The fact is, you are worth what you can get someone to pay you. And this applies whether you are a sports figure, a television personality, a banker, a businessman, or a futures trader. But the competition is fierce. Remember, there are millions of kids out there playing basketball, but there is only one Michael Jordan. As in any competitive venture, the few will earn the lion's share of the spoils. Even so, if trading is in your blood you definitely should give it a try.

Who you are — your psychological makeup — is far more important to your success than any trading system you could ever purchase. I know this because I've taught totally mechanical trading systems that should, one would think, have identical results for a number of users. But guess what? No one — and I mean no one — ever has identical results. Why? Well, trader A starts out with three winners and decides he no longer want to be a one-lot trader, but now fashions himself a five-lot trader. Then the inevitable drawdown occurs. I don't have to do the math. Trader B, on the other hand, buys the system a week later, during the drawdown period. His first three trades are losers. When signal four occurs, guess where trader B is — on the sidelines. He wants to watch the market for awhile. I've seen this occur so often that I consider it a rule chiseled in stone: no one will ever have identical results with a mechanical system.

A MOMENT'S HESITATION MAKES ALL THE DIFFERENCE

I recently experienced this propensity among traders first hand. I had been helping a client who understood LSS but had recently encountered a drawdown. The losses were nothing serious but still they were sufficient to give a new trader reason to second-guess his activities. We had a buy signal for a trade that was to net 250 points in twenty minutes. It was a perfect trade. But the timing was critical. From signal to execution, the window of opportunity was no more than three

minutes at the most. In five minutes time, it was a hundred higher and climbing. That's when the phone rang.

"Did you get the signal?" he asked.

"Of course," I replied. "Isn't this great?"

I sensed his hesitation and knew immediately that he didn't have the trade. He had missed it, he explained, because the last few trades had been eating at his equity and he wasn't sure if the system was working. You can't take a winning signal to the bank. So you'd better take the trade.

Trading consultant Ralph Vince wrote a sophisticated and complicated book on money management that stressed the important of maximizing one's opportunities. In his Portfolio Management Formulas (John Wiley & Sons, 1990), Vince has an in-depth discussion on what he calls "Optimal f." In a nutshell, Vince proves mathematically that a winning system requires a greater commitment following a drawdown period. This assumes, of course, that the system can be shown to make money over time. (Please note: if you are trading a losing system, increasing your size is definitely not recommended since it will certainly put you in the poorhouse faster). In following his progressions, however, the money at risk quickly becomes significant to just about everyone regardless of the size of one's margin account.

I've never seen anyone one-lot themselves to any serious money in the market. So you should take Vince's advice to heart. You must take an aggressive approach if you are going to make any significant gains in the market. One-lot trades are fine if you want to gain some experience in the market. It will give you a feeling for your emotional ups and downs as

you follow your position. But most of the money is made on relatively few trades. And these trades must be the ones where you have "loaded the boat" if you are going to make any significant money.

You need to look at the market in terms of your own personal goals. Are you interested in just avoiding losses in the market? Or are you interested in making large profits? The two are mutually exclusive. The risk-adverse newcomer, who is among the former type of trader, does everything in his power to avoid loss. Ironically, this particular stance prevents him from making any money. I used to know a floor trader who prided himself on never taking losses. On some days, he'd get up at five in the morning, travel an hour on the train, come down to the floor and stand around all day looking for the perfect trade. Nope. Not today. He couldn't find the surething he was looking for. When he did take a position, the slightest adversity would send him scurrying to the sidelines. "I sold it at twenty," he'd say, "but then it went up a tick and when it came back to twenty, I scratched the trade." He loved scratching trades. As a floor trader, his commissions were negligible. Ironically, he had an excellent feel for the market. He could tell you the top or bottom price by a tick or two. But he couldn't seem to make any money. After ten years on the floor, he was still doing one-lots.

Accompanying his pride in never sustaining losses was an absolute contempt for my method of trading which was to go for the big money every day, occasionally getting murdered in the process.

"At least I don't have losing days like you have," he'd

proclaim. I could see it was a point of pride for him. But when we'd go over our morning statements I'd also see a trace of envy in his eyes. Occasionally, I would have a five-figure winning day — something, I'm certain, he'd never experienced.

But what, really, is the alternative? Do you really think anyone can have four- or five-figure winnings days without the bad days? I don't think so. And I think you are kidding yourself if you are looking for a less risky way to trade.

I'm often amused by the immaturity of many futures traders. They want to play, but they don't want to pay. And they especially don't want to pay the dues necessary to learn how to trade. It is a little like a college graduate entering medical school and demanding a $250,000 salary the first year. He's shown up. Isn't that enough? This analogy is not as absurd as it seems. As someone who tries to teach would-be traders about this art form, I often find people who want to be guaranteed their profits despite their personal shortcomings — which, as we've discussed, can often be considerable.

A good example of how novice traders repeatedly create losses is with the use of stops. I never place stop-loss orders when I'm in the market because I know their hazards all too well. The floor will gun for them whenever possible and most traders place them exactly where they shouldn't be — namely, within striking range. Moreover, under most circumstances when a would-be stop is hit, there is a clear-cut opportunity to get out at a more advantageous price — if you have the discipline not to panic or commit some other self-destructive act. When I explain this to new traders, they inevitably look

at me blankly and say something like, "Well, I can't afford the losses that you can." But this is exactly the wrong attitude. They can — and do —sustain larger and more frequent losses precisely because of this emphasis on "protecting" themselves against loss.

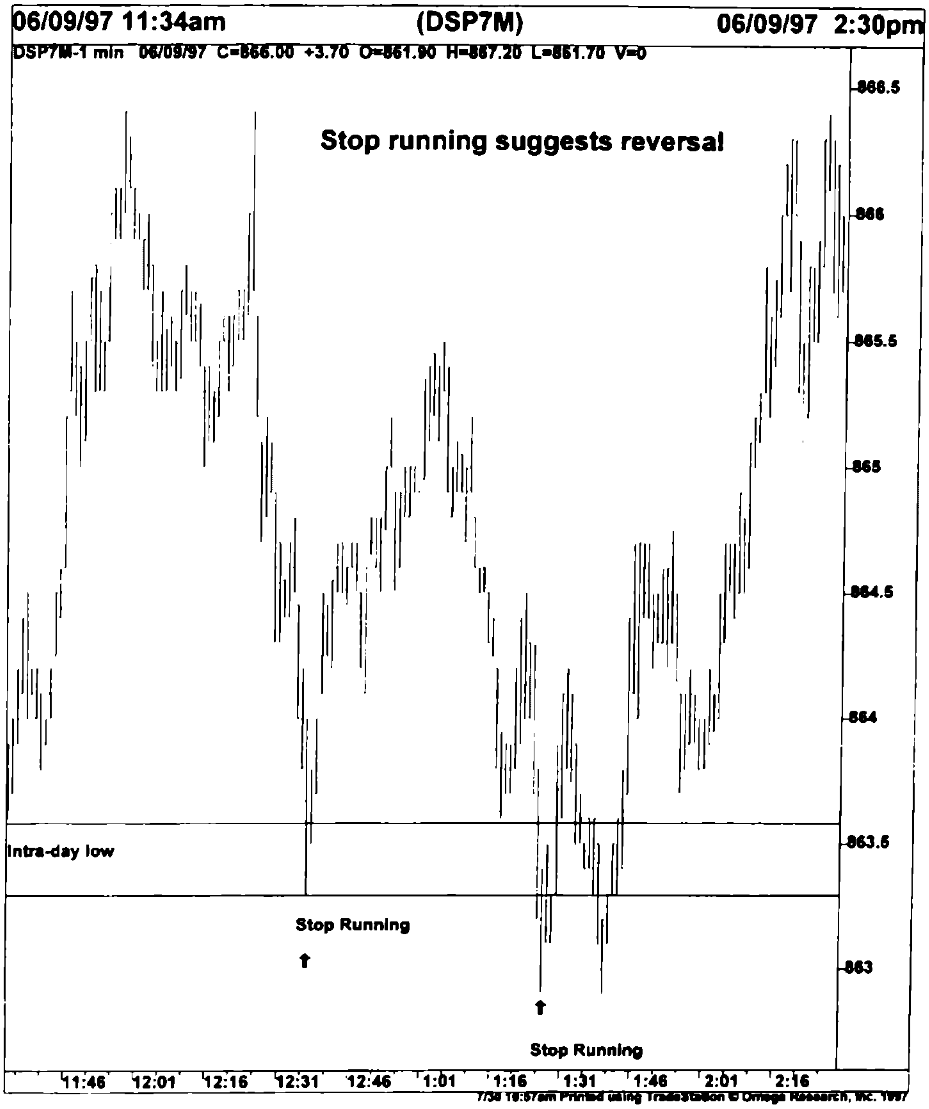


Chart #3: Once you have intra-day highs and lows, you have stop-running targets on the chart. Any penetration of these prices constitutes stop-running *if* prices snap back within two or three minutes. A close at the extreme end of the bar is further confirmation that the move is over in the direction of the stops.

The risk-adverse stance becomes particularly worrisome on a day when you are on the right side of the market and everything is going according to plan. The market is going your way? No problem. We'll just move up this stop and protect those profits. Whoops! Stop got hit and the market soared out of sight! You missed the big part of the move. This happens with regularity among individuals who insist they take a profit. But the point is, you need the big profits to offset the inevitable losers. Getting out prematurely because you are afraid of losing money is not the way to win the game.

If you see yourself in this scenario, be assured you are not alone. But if losing the money is so painful to you, perhaps you would be better off working at another job until you can approach the market with the notion that the money is truly secondary. You can't trade with your eye constantly on the size of your equity account. This is a little bit like driving with your eye squarely on the rear-view mirror. Sooner or later, you are going to miss what is right in front of you.

In 1987, I published a book, co-written with Merc trader Barry Haigh, West of Wall Street. I learned a great deal in writing this book because Barry was truly at the top of his game at the time we did the book. One of Barry's contentions was that he wasn't afraid to reveal his secrets because so few people could duplicate what he did — doubling-up and reversing, averaging in on multiple positions, trying to fool the pit by pretending to bid on a large number of contracts when he really wanted to sell, and so on. True, some of this information pertained exclusively to floor traders. But the point was, this is a tough game and you have to be aggressive to win.

When the book was published and I heard from some of my readers, I was shocked by some of the responses. You guys make it sound too difficult. I'd prefer a formula or two for pinpointing the high and low. I can't take those risks. You know the excuses. The point is, people wanted to be lulled into thinking there was an easy way to generate profits.

There used to be a local financial television program in Chicago called "Ask an Expert." The premise of the show was to disburse financial information on stocks and commodities. But really it was a thinly-veiled advertisement for the people who appeared on the show, primarily stock and coin brokers. Viewers would write or call in and the host would "interview" participants. Sort of a poor man's "Wall Street Week." The amazing thing was that the show regulars always had an opinion — on everything. When you think about it, this makes perfect sense. They were fulfilling a legitimate need — namely, the public's need to think that someone out there had all the answers. People wanted certainty and they were getting it. I just hope the price wasn't too high for most of them.

Occasionally, I have to catch myself lest I fall into a similar trap. But I try to help the person who inquires about hot tips, by saying: "You're asking the wrong question. No one knows where the market is going." Moreover, the good news is you don't need to know. The real question, however, should be: "How can I learn how to trade?"

You'd be surprised how few people really want to know.

For those who do, there's a lot to learn. I don't think the learning process ever really stops, but for most of us, master-

ing the learning curve can be an arduous task at best. Typically, the unseasoned novice brings with him a number of myths into his trading activities. First and foremost, of course, is the notion that trading is easy. You simply buy here and sell there and collect a lot of money. But most try to take on the professional traders when they are undercapitalized — a truly big mistake. Not having sufficient money to play the game makes cowards of us all. In fact, you can hardly allow yourself to think properly about the market when you are focusing on something that is entirely secondary to the task at hand — namely, beating the market. Yet, this is precisely the handicap that most new traders bring with them.

DON'T THINK ABOUT THE MONEY

If you doubt my word on the importance of not thinking about the money, try doubling or tripling your normal size and see how quickly your reasoned approach goes out the window.

At the slightest hint of adversity, you will panic and reason will no longer play a role in your decision making.

I'm reminded of a retired airline pilot who paid me a visit a couple of years ago. His hobby was painting underwater scenes in his studio on the coast of New Jersey. His plan was to spend his retirement years in his seaside studio and do a little trading on the side. He was planning to take a trade and return to his painting while the position grew profitable. With a single S&P contract valued at over a quarter of a million

dollars, I told him to take just a one-lot and see how he felt. I knew he wouldn't feel like painting. After seeing me experience an afternoon of sheer frustration and sizable losses, he changed his mind about trading. He returned to New Jersey and gave up his idea about trading. Two days later, of course, I'd recouped the day's losses and earned a sizable profit. But by then he'd already given up.

As a futures trader, I have but one goal — to make money. This may seem obvious, but you'd be surprised how many people are in the market for other reasons. Thrills. They like the action. Or ego reasons. They want to buy the absolute bottom and sell the absolute top. Perfectionism. Some people, apparently, even want to beat themselves up. I agree with the wag who said if you don't know who you are, the market is an expensive place to find out.

I also agree with the notion that everyone gets what they want from the market. Some want to win, others to lose.

There may be a million easier ways to make money, but I'm convinced I'm playing the greatest game in the world. I've just come off a five-day mini-winning streak where I made more money than I used to make in a year working for a living. How many people can do this? How many can experience the anticipation and the ultimate sense of triumph connected with successfully trading the market?

TRY TO MAKE MONEY EVERYDAY

It is true that not every trade will prove a big winner. In

some instances, you will overstay the market; in others, you will exit prematurely. There is frustration involved. But my goal is to try to make money every day. Nor does it have to be a big score. If you could clear just $500 a day, you would be earning a six-figure income. Although I suspect it isn't possible to win everyday, you can tailor your trading around those handful of big days a month and toss in smaller orders for smaller profits, trying to capture the up-and-down movement.

I'm a firm believer in capturing the big move. The reason is, you are certain to have your share of losing days. But if you manage your win/loss ratio properly, the profits on the winning days will far offset the losing days. Most new traders, of course, do it the opposite way. They hang onto the losers in hopes of the market coming back. The winners, on the other hand, are taken quickly on the justification that you'll never go broke taking a profit. But you most certainly will because the winners must offset the losers in order to achieve a profit.

Again, we are dealing with a deep psychological point of view. Are you primarily motivated to make money? Or would you prefer to simply not lose money? The two stances are actually far apart. I am reminded of an incident that occurred one day when we left the exchange early to drive out to Arlington Park to spend a day at the races. One of the traders joining us that day was an individual who hated to lose money. In fact, he was so risk-adverse that at the slightest sign that he was wrong in the market, he'd exit immediately. The problem was he had difficulty making any serious money because he always had one foot out the door.

I realized he'd never been to the races before, so I explained how the betting worked. How if you bet to win, the horse had to come in first in order to pay on the ticket. Of course, I also explained Place and Show betting as well as the exotic bets such as the Perfecta and Trifecta. Immediately, he seized upon Show betting because you won if the horse came in first, second, or third. His strategy was to bet the horses to finish in the money.

As the day developed, he naturally had his share of winners and, as we were approaching the last race, he was up about $20 on the day and I was out about $100. I wanted to give myself the opportunity to make some serious money and go home a winner. The $100 loss wasn't bothering me. So I decided to take five different combinations of Trifecta tickets (which required the horses to cross the wire first, second and third in exact order). Maybe lightning would strike. It did! The winning Trifecta ticket paid over $1,000. My friend finished his first day at the races up $20. The point is, I was setting myself up to win. My friend, on the other hand, was primarily interested in preserving capital, or not losing. It is a different attitude.

THE BIG SCORE

Now, you might ask, weren't the odds against winning more than $1,000 on a $2 bet quite high? Yes. I knew that when I made the bets. But consider the risk/reward ratio. I parlayed five $2 bets into over $1 ,000. The same $10 placed

as a show bet would have returned only five or six dollars in profit. That would have ensured a losing day. Ask yourself: what is the alternative? For me, the whole purpose of futures trading is to take a relatively small amount of money and turn it into a significant amount.

Yet, some newcomers to the futures market want to have the "certainty" of the place or show bettor. They want to take a one-lot and place a stop. Their reasoning, of course, is quite understandable. Once they become successful doing one-lots, they can move up to larger positions. For those with limited margin, this strategy makes sense; but it is unlikely to work. Unless you are willing to identify the best opportunities and then "plunge" on these highly-likely events, chances are you are never going to be in a position to make any serious money. After years of analyzing my own trading results, I came to the conclusion that most of the profits are made on relatively few trades. And I've found this to be the case with most successful futures traders. Indeed, some of the biggest players in the market make the lion's share of their profits on just 10 percent of their trades.

For instance, let's assume there are twenty trading days a month. Out of this number, you will likely make some excellent profits on just four trading days — if you are willing to take larger positions on the best trades. This leaves 16 trading days. On these days, you will perhaps win money on eight days and lose money on the other eight — about fifty-fifty. The problem is that the winning days will be cancelled out by the losing days. That leaves the original four big winning days as the time when you will secure your profit.

I know what you are thinking. In that case, I will limit my trading to just those four trading days. Wrong. You don't know in advance when these days will occur.

On the floor in Chicago, I'd observed that most of the really wealthy traders were setting themselves up for the big score. During the 1987 market crash, I had a friend at the Chicago Merc who managed to make over one million dollars. How did he do it? Simple. He'd been anticipating just such a break — had it not been hard work and had simply been happenstance, you might have said that he'd been at the right place at the right time — and he bought put options on the S&P 500, sold calls, and shorted futures contracts. You might say he had a serious point of view on the market. He was looking for the break and backed his opinion with impressive sums of money. History was on his side. The strategy paid off. The point is, you don't need many such winners to come way out ahead. Now, you might say that this floor local wasn't day-trading, so what's the point? The point is, whether you are day-trading or position trading, you must enter the market with the goal of hitting that grand-slam home run. A more inexperienced trader would have found a way to defeat himself by taking just a minor, small profit or running at the first sign of adversity. There are a million ways to lose in the market, but relatively few ways to manipulate the odds solidly in your favor to win. One way is to seize the opportunity and go for the big killing.

HOLDING DIAMETRICALLY OPPOSED OPINIONS

It's been said that the mark of an intelligent person is the ability to hold two diametrically opposed opinions in one's mind at the same time. Here I'm talking about the ability to hold onto one's position in the face of uncertainty while being able to cut and run at the same time. How many futures traders have been ruined by the inability to sense the danger and run? The tendency to "freeze" at the switch is a real one. I've known people who were paralyzed by the notion that the market was against them and getting worse. They simply couldn't function in the face of unacceptable losses. Yet the other side of the coin is likewise real. How do you react when your position is becoming more and more profitable? If you think this is an easy skill to master, you are wrong.

While growing profits often require patience and courage, you must be rigorous with yourself in dealing with losses. The only losses I regret are the ones I didn't take sooner. Learn to love your losses. Don't let them be a reflection on your success as a trader.

My friend and fellow trader, Larry Williams, once told me a valuable piece of advice on this score. "You know," he explained, "I'm always wrong in the market."

Granted, I was indeed surprised to hear this.

"When I win," he went on, "I never have enough contracts. And when I lose, I always have too many."

After thinking about what he'd said, I realized he was one-hundred percent correct.

I've noticed over the years that the real losers are those people who can't deal with the losses; the winners take them as part of the normal trading process and move on. I know this is a difficult psychological feat to master. Losses can eat away at your self-confidence. But don't let them. If you knew the number of times that incredibly successful traders lose, you wouldn't believe it.

"SMOKE COMING UNDER THE DOOR"

Unfortunately, there are no hard-and-fast rules regarding when to exit the market. But learning to run is part of the art of successful trading. Preferably, you can learn to exit before the need to run becomes widely known. One successful trader once deemed this as "looking for smoke coming under the door." That's the time to run. Not when the whole building is on fire. As you may know, the whole issue of stops is tied up with this notion of where to exit. Traders tend to act in a herd instinct. For this reason, the stops are typically all bunched together - above and below the intra-day or inter-day range. You don't have to be a genius to know this. So when the market starts soaring or free-falling, guess whose orders are driving the market? That's right, the stop-loss orders. And the traders whose stops are being triggered are losing money with every tick.

Just this week, I had a signal to buy at the price of forty in the S&P. As it developed, forty was the resistance as the market bounced back and forth from the lower even to forty, two

or three times. This told me two things. First, the longer it stayed in this range, the better the move would be when it broke. Second, there would be stops on either side of the range. Sure enough, having watched the market gyrate in this narrow range for close to 45 minutes I immediately jumped aboard as it broke into new high ground. The market soared on the dual driving forces of short-covering and new buying. Once it stabilized at a higher price, a new range was establish. This told me there would be more stops. Now, here's how you have to look at a situation like this. Ask yourself: Who's in trouble? And who can they get the easiest? The market inched higher. The buy stops were about to be hit above the market.

Then it took off. This time, it was an opportunity to sell that was too good to miss. The panicked buying soon evaporated and the market began to drift lower.

I can't emphasize enough the importance of understanding the psychological factors at work here. People get very emotional about money — especially losing money. It causes them to do things that they wouldn't ordinarily do. This is your opportunity. Also, watch for that quick move back. When there is a short-covering rally, you almost always observe the same phenomenon. First, the market goes quickly higher, rising on every tick. Then, it goes dead at the top for just a beat. The next tick is lower and we are off to the races on the downside. Thus, if it is fast and it cannot hold the price level, chances are the buying has vanished and it is time to think about selling. I see this happen every day. But you must be able to recognize it in order to capitalize on it.

MARKET BEHAVIOR AND TIME

You will want, of course, to be able to tie this all together with the time of day. Remember, the best trends occur in the early morning shortly after the open and, typically, the final hour or final two hours of the trading day. The noon time tends to see meandering prices.

This is when the market becomes "thin," meaning it lacks many buyers and sellers, and the moves are relatively meaningless.

I don't know what percentage of the successful trading experience is comprised of psychological factors except to say that it is high — perhaps 80 to 85 percent. Nothing is more destructive of the trading process than losses and nothing more encouraging than profits. The experience of having a string of winning days (despite inevitable setbacks and disappointments) will stand you in good stead when the time comes to commit serious money. But if you lose the discipline to trade, the losses will eat at you until you will be afraid to take a one-lot. If you ever reach this point, chances are you may try harder — which will only compound the problem.

THE PARADOXICAL NOTION OF WINNING

Making money is paradoxical. When you really must win, you never can; when you are relaxed and carefree about trading, the profits pile up. If you are having problems winning, the money may be too important to you. I'm not suggesting

recklessness here. Only that a strictly tight-fisted approach won't work. Ironically, successful trading requires a certain generosity. You have to learn to cast bread on the waters. It will often come back to you.

I remember having lunch one day at the Merc Club, which is an exclusive club for Chicago Mercantile members, with a trader who insisted on sitting with his back to the ticker because he had such confidence in his position. He'd say, "It's at eighty, isn't it?" I was amazed that he knew the market well enough to be able to tell the quotes without looking at the price ticker.

A WINNING SYSTEM GENERATES CONFIDENCE

It is this kind of confidence you need to trade well. One thing that gives me confidence is a winning system. I don't care what approach you use in the market, you must have some sort of systematic approach in order to win. With a winning system, you can take losses in stride because you have confidence that, over time, the system makes money. This confidence is especially important when you are in a losing streak. That's because you will understand intuitively that this, too, will end and profits will come again.

Too many traders take a seat-of-the-pants approach to the market. This amounts to simply guessing. What's to say that Tuesday's guess might prove equally disastrous as, say, Monday's? Moreover, when you guess, you cannot even trust

the winners. This is because, rather than having derived your profits from a significant knowledge of the market, it was just a lucky guess. And luck, as we all know, can change.

AMATEURS ALWAYS QUIT AT THE BOTTOM

In terms of your trading results, you want to insist on statistical comparisons. How are this month's profits against, say, last month's? Has the system had a comparable drawdown before? Ironically, the real measure of the turning point in a trading system's results tends to be when the neophyte trader gives up. That's when it is ready to work again.

Remember, it is only human nature to want things to be easy — whether it is trading or any other type of human activity. Once adversity hits, however, you truly separate the men from the boys.

Being able to go on in the face of the adversity is what makes a winning trader. But you must have total confidence in what you are doing in order to trade properly. This is why I tell would-be traders that they must have the experience of having traded in order to truly appreciate the benefits of a trading system. They must understand that patience, discipline, and nerve play an important role in their trading success. Otherwise, the first setback will cause them to quit.

There are countless examples of this failure of will harming one's trading success. You need to identify when and where the opportunity will exist — both in terms of time and price. Until you are able to identify these specific points <u>in advance</u>

of their occurrence, you will not be sufficiently armed to trade properly. Yet, here again, as so often happens in trading, you face a paradox.

LOOK BEYOND THE OBVIOUS

Where, for example, is the market safest to buy — or sell? Not at the low, if you are buying; not at the high, if you are selling. Indeed, except in retrospect, these are highly risky spots. For buying, the best opportunity often exists at the most precarious time of the day — namely, when it is soaring into new high ground. And, of course, the reverse is true of selling. You want to learn to sell new lows. Some of my best trades occur when I jump on a rising trend, indeed often buying the high of the day. You'd be surprised how often this strategy works. But you must have confidence to trade like this. And, significantly, you must have the knowledge to know when not to employ this strategy. Often, it pays to look beyond the obvious. The best trades are the subtle ones which come out of nowhere and turn into substantial gains.

Let me give you an example. Not long ago, my LSS trading method signalled a buy entry at the top of the intra-day range. Normally, I wouldn't have trouble taking this trade. But I was suspicious of the trade because the bonds were at the low of their intra-day range. I stood aside temporarily, waiting for a stronger confirmation. Sure enough, the weak bonds were a tip-off that S&P prices, at least in the short-term, were headed lower. In fact, they took a shot at the stops

below the intra-day lows. With that accomplished, the market was free to rally immediately. As it soared upward, I jumped aboard. This was my perversity theory of the market come to life. To go up, the market first has to go down. That way it kills a few would-be buyers, taking the contract from weak hands into strong hands. Only then is it truly free to rally. The signal, of course, proved quite profitable.

Can you see how a trader who had entered the market on a whim might have been shaken out? It is my belief that if you enter the market for the wrong reason, chances are you will likewise exit for the wrong reason. Have a plan. Try to make sense out of a sometimes seemingly chaotic situation. The perversity theory often provides an accurate description — down means up, and vice versa.

The value of the topsy-turvy viewpoint in the market cannot be underestimated. Not long ago, I had a strong indication the market was going up. But it was struggling and I tried to make some sense out of what was happening. It would go up and the sellers would knock it down again. After watching this for ten or fifteen minutes, I realized what would have to occur for the market to go higher. That's right. It would have to go down. But not too far down. With the S&P's trading at eighty and ninety, I had to pick a price. I selected the lower forty-five. That's where I would buy it — but would it go there? It began to drift lower. When I saw the fifty print, I grabbed the phone.

"Buy me eight at forty-five!" I yelled.

"Forty-five on eight," the desk man repeated the order. He told me the ticket number and I wrote it down. "You're filled."

The market never looked back, rising immediately in what proved to be a lucrative trading opportunity.

When you can buy the bid on the low like this, you must be doing something right. I know that the floor loves to pick off the "paper," or public orders. Had I been standing in the pit itself, I never would have found a seller to take the other side of this trade. But because I was the "paper," they were all over me, thinking, "Here's a foolish customer."

Ha! The hapless floor local never saw a tick's profit. He was stuck. And had to buy back the contract at a higher price.

What if I'd picked forty as the entry price? Might I have missed the market? Maybe, maybe not. So much depends on what some nervous floor local is thinking at that moment. The way the floor operates, a one-lot floor trader can — and often does — take the market lower just as surely as some large program trader might. His bid or offer is the market at that particular instant and there isn't a thing the big trader can do but hope the offer meets a strong bid or his bid meets a strong offer, depending upon his point of view.

Given the open-outcry system, you often get some interesting aberrations in price which the astute trader can capitalize on. It is not unknown for the big traders to get the ball rolling by "high-balling" or "low-balling" the market on one-lots just to create a little momentary panic.

How does this work in practice? Say you are "five bid, at ten" in a stabilized market. (The word "at" always connotes selling in the financial short-hand of the floor). But given a little incentive, anyone — locals and brokers alike — can take down the market in an instant.

"At five."

"At even."

"At ninety!"

These are all offers. There are no bids. All of a sudden, the sellers are "offering" seventy-fives and the bottom is falling out. The point is, the bid must be at the last bid or higher; the offer must be at the last offer or lower. A single, panicked one-lot trader can change the value of the S&P 500 futures in an instant, resulting in millions of dollars in losses or gains for some traders. If his panic is offset by a value-conscious trader on the other side, of course, his offer will soon find a buyer and the market will remain unchanged or go the other way.

Accordingly, to avoid surprises, the first thing I ask when I call the floor is, "Where's the market?"

This is because the numbers on the screen will mean nothing if there's been some sudden development. It can take as long as ten or fifteen seconds for a consummated price to appear on a computer screen, and, in the business of futures trading, that can be a lifetime! So I want to know exactly where the market is trading.

Another reason I ask is because I want to know the spread. A "double" (55) "at sixty" market is a lot different from a "double-at-eighty" market since a wide spread suggests thinness, or a lack of liquidity. Or even worse — market panic!

Another thing I listen for is floor noise. Typically, if the market is heating up, you can tell it from the noise. A quiet market can be trouble. But noise suggests the market is either running or about to run. I love panicked markets, just as long

as I'm on the right side. That's when you can make the most money quickly. The problem comes when the market moves against you on panic. That's when you can be in real trouble.

Having sized up the market by asking the spread and listening for the noise level, I'll typically select a price. Having been told we're sixty-five at seventy, for example, I'll often select a price.

"Buy me seven at sixty-five," I might say.

"Sixty-five on seven," the order clerk will repeat.

Since my brokerage house's desk is in the front row just feet from the pit, I can often hear the floor broker bidding my order. It is typically filled in seconds. If not, I'll be told, "It's now seventy at seventy-five, seventy-five at eighty," or whatever. That requires a judgment.

Do you tell them to work the order and hang up? Or do you cancel the order — or even go at the market? So much depends on whether you are really eager to get in — or out — that it is hard to say exactly what strategy is best under what conditions. In general, however, I like to pick the price getting in and out — under ideal circumstances.

More often than not, however, the conditions are not ideal and you are worried something untoward is about to happen and you just go with a market order. The same is true if I want to buy, say, eighty-fives and the market is suddenly trading at seventy. I might grab the trade with a market order, considering it a gift. Chances are, I found a momentary lapse in the market and I am able to capitalize on the situation. The other side of the coin occurs when the market is about to run. Then, you don't have to time to finesse the trade. Simply

buy it (or sell it) and forget about the final tick. I've seen so many good trades get away because the public trader wanted to see if he could beat the floor out of a tick or two.

My thinking on fills is succinctly simple. A "good" fill is a bad sign; a "bad" fill means you have the right side. The only exception to this is the "Market on Close" (MOC) order. Here, when you are selling into a closing market of panicked short-sellers buying at the last possible moment (and vice versa on the down side), you can get some truly nice fills, often the high or low of the day.

There are countless situations where, if you track the market carefully, you will find opportunities that are waiting to be seized. But don't be too quick to grab each one. Not long ago, we had a day where the market was spending a lot of time in a range — which I was certain would be broken prior to the close. Finally, after what seemed like hours of drifting behavior, the market edged higher and was knocking on the door of the highs. Something inside me said, "This is it. It's going to run higher." I almost picked up the phone. Guess what happened? That was the high of the day. It went lower and broke and never looked back.

The problem? The trade was too pat. Too obvious. That sense that I had a sure-thing, a 100-percent guaranteed lock on the trade is what frightened me off. It is always worrisome when you "know" where the market is going. Because if you know, so does everyone else. And when everyone thinks alike . . . well, you get the picture. Moreover, the certainty of the trade violated my law of paradoxical behavior. Instead of blindly betting on sure-thing trades, look beyond the obvious with a certain degree of sophistication.

One thought I always have when I take a trade is about the guy on the other side. After all, if you are right, he is wrong. Do you really think the floor professionals on the other side of your trades are always going to be wrong? There could, of course, be a million reasons why someone else is buying when you are selling. He's buying to cover a short position which he instituted higher up. He's taking profits then. Or, he's just a scalper who immediately plans to sell the offer. Or he's simply wrong. The point is, you very often wouldn't want to trade sides. He's bucking the odds just like you. You are both in a precarious position (this is especially true right after you initiate the position) and, given the notorious S&P market where volatility is king, chances are in the moments to follow you will both be proven right — or wrong!

While I place a premium on intelligence in being able to beat the market, I find that many new traders tend to think too much. I'm reminded of the advice that Anthony Quinn, playing Zorba the Greek, gave Alan Bates along this line. ("Boss, you think too hard.") The market, after all, can only go in one of two directions, up or down. So if you try to analyze every little fluctuation on the screen, you are going to drive yourself crazy. Indeed, over the years, I've grown suspicious of Ph.D. types who have a tendency to over-analyze everything.

This insistence of "proof" for what can best be described as "catching lightning in a bottle" is difficult to understand. I am often asked to "demonstrate" the efficacy of my LSS system by revealing several trades or providing names of current users. I have no problem with this, except to explain that

a handful of trades or even one user's experience with a given system is not representative of anything. Perhaps you were in a winning streak that week —or the system was losing miserably. Perhaps a given user is risk-adverse and misses all the winning trades because the experience of losing money on the last trade has left him unable to pick up the phone and call in the order. In the general scheme of things, such a small sample is meaningless.

Along the same lines, I'm often asked if someone can come by and watch me trade. I know what they are looking for but I'm not sure I can provide it. Trading is not a gimmick, something which can be easily taught in a day or two. On the other hand, knowledge is so important that anything you learn about sound trading practices can be helpful. The point is, you need to disabuse yourself of the notion that trading is an easily acquired skill.

What, then, is the value of a reasoned systematic approach? Simply that it enables you to get the percentages working in your favor. You want to have a framework within which you can understand the entire concept of markets and trading. Given this notion of how markets behave, you will not be surprised by what happens. For instance, as a seasoned S&P trader, I can tell you that come tomorrow morning, the market will probably open steady to higher, trade down a little in the early going and then make a run upward. It could be the reverse, of course, but there will be a move. This is opportunity one. Second, after the initial rally or decline, the market will find some stability, and chances are a countertrend will occur as it works in the opposite direction. This

trend is harder to capitalize on. Lastly, in the final hour or final two hours, another trend will probably emerge which will enable you to make some good money. This is opportunity two. There are days, of course, when the market is choppy and essentially trendless. In this case, the trends are harder to find and more difficult to trade.

This is not brain surgery. I only need a very small part of one of these moves to make serious money. But to do so, I must have some notion of what is happening. Rumors and news will drive the market. As for the genuine underlying reasons, I could care less.

More importantly, spending too much time trying to analyze the market can be counterproductive. As for trading on fundamentals, you can often see the market go up on one piece of news and down on another. The fact is, it is far more productive to ask yourself, "Who's in trouble?" By doing so, you can appreciate why the market moves as it does. This is especially true on those days when the market trends lower. First, you will find cautious bargain-hunters trying to pick a temporary bottom; next, as additional support lines are broken, you'll find some serious selling; and, right when everyone thinks the market is finally going lower, you will find the counter-trend kicks in — at least temporarily. By late in the afternoon, the funds will be selling enormous quantities and it will seem like the world is coming to an end. The next day, of course, you will get a rally.

This is psychology, not reality, driving the market. People are fearful. Where "true value" exists is simply an academic exercise.

"I love to sell new lows," a successful trader once told me. It was only in hindsight that I recognized what he was really talking about. First, the market has to go to new lows to go lower; and, second, it's a sign that a tremendous number of stops are about to be hit. Looking back, I can see how it also fulfills my bad fill theory. It may be a lousy fill, but it often makes for a good trade.

As a student of the market, you want to reflect on what really works as compared to what most traders do. In recent weeks as I write this, the market had a day when the Dow had plummeted close to 100 points and the S&P by approximately 1,100 points. I must have had more than a dozen calls that day, with each caller remarking on what a dramatic day it was in the market. Not one had even a small portion of the move.

Ironically, the least risk exists before the move is known — the precise time when we are reluctant to touch it. Once the news is out, the trade becomes even more risky. Well, it has already come down this far, and . . . you fill in the reason. About half way down: "If I sold it now, it would surely come back." And so on. This on a day where a one-lot earns you $5,000!

I would like to devise a meter that reads the exact percentage of risk. For instance, five minutes after the open, it might read that sellers have a 40 percent chance of losing their money if they placed their stop seventy-five points from entry. However, once having sold and once the market goes down, the chance that the same stop order will be hit becomes less — let's say 20 percent. This suggests you could either leave the stop where it is or move it lower to protect profits

(this, of course, would raise the chances of the stop being hit). By the end of the day, with minutes to go, the percentages could rise to 99.99 percent in your favor. But to get to this point, you would have to withstand the initial anxiety of having the stop within target range.

What counts in the market? Speed, velocity, volume, advancing versus declining issues, premium, cash prices. To take all the important factors into consideration and blend them into a comprehensive and viable framework of trading is a difficult task. Yet this is precisely the challenge that every would-be successful futures trader faces. How do you judge today's rally versus the one that occurred last week? Prices are still going up, but does it have the same meaning? Not always. Indeed, some rallies can provide some of the best selling signals for anyone capable of ferreting out the hidden signs of inherent weakness. In recent weeks as this is written, the news reports have been of a singular theme. The market has been making record breaking highs day after day. But to those of us who live and breathe the market, the rallies have all been anemic. Any excuse even suggesting that these levels are unjustified will cause the market to break. Hence, the 100-point break in the Dow on an ever-so-modest rise in interest rates.

The real secret of winning, however, is knowing when the market is about to change. This is where the serious money is made. First, you can look at this in terms of the daily price action. When, essentially, will the breakout come? If you are tracking the market in its early uncertain stages during the day, you don't know. But once an intra-day trading range has

been established, the parameters become more defined. You have a support, you have a resistance, you have two definable breakout points. The fact is, most traders are asleep at the switch when the real move comes and you have to be open to the notion that change can — and will — come whether we are discussing the direction of today's prices or prices ten weeks from now.

One of my favorite rules concerns one-tick new highs or lows. This works exceedingly well in both bonds and S&P's. Essentially, the rule goes like this: if you have a one-tick new high and the move fails, the market is going lower; and the reverse applies as well. I call this price rejection.

Notice how nicely this fits into the perverse theory of the markets. One tick new lows which fail means up, and vice versa. What precisely is happening in this scenario? The market is looking for direction. The buyers are doing everything in their power to take it up and the sellers are doing everything in their power to take it down. The stops are on either side of the market. Guess where the easy pickings are?

I don't use resting stop-loss orders and here's why: Years ago I was trading gold and decided to place a stop under the market (just in case). The stop was filled under the official low of the day and the market soared higher. It was not a small position either. I never forgot the sense of frustration I felt knowing I had let them beat me by doing something stupid —namely, allowing someone to know where my stop was.

On that day, that stop being hit was the sign that the market was ready to take off. There are other stop-placers out there today, putting their stops right in the line of fire. Once

they are hit, the market usually asserts itself in the opposite direction.

I must stress that I've seen this precise scenario occur many, many times since that day.

By the way, the tradition of "gunning the stops" is an honored one among the floor trading community. There is nothing illegal about this practice, so you had best learn about it before it costs you some serious money. The rule is, if the stops are within shooting distance, they will be hit. So, as a defensive posture, you have to ask yourself: who can they get? On the most frustrating days to the public, the floor has a ball. These resemble military actions where the market is first taken up to generate the stop-loss buy orders at the top and then down to generate stop-loss sell orders at the bottom. Guess who is taking the other side of these trades? Guess where the market typically ends the day? That's right, unchanged back where it started from. Despite an unchanged closing price, these can be very lucrative days for the winners. The floor traders call these "search-and-destroy" days.

The existence of "search-and-destroy" days necessitates a very pragmatic approach. Ask yourself: What kind of day are we having? Tell me that and I'll tell you how to trade today. It makes a big difference. Perhaps the single most important contribution of Peter Steidlmayer's "Market Profile" concept is that it gives you a graphic representation of the kind of day that is emerging. For those unfamiliar with Steidlmayer's innovation, the profile tracks the prices that have occurred within specific half-hour time brackets during the day. Typically, therefore, on a so-called "normal" day, the

high and low would be made quickly (just a single time bracket), whereas the other prices in the middle of the range were typically repeated many times over and over again in a wide variety of time brackets. As a result, there would be a decided range of prices where most of the trading occurred on any given day.

On a computer screen, this resembles the classic parabolic curve with a bulge in the center and tapering ends. When identified early enough in the trading session, the mid-trading point serves as an equilibrium level. Hence, you can often buy if the current price is below the area where most of the trading activity has occurred or sell if the current price is above that level of prices. This non-trending type of market can be a scalper's dream. The only real risk occurs when the market starts to change and the market goes from a "normal" non-trending day to a "trending" day. Then, as always, you have to be quick on your feet to recognize the change and trade accordingly.

The interesting thing about "Market Profile" is that no two individuals ever interpret it the same way. Hence, it is like charting, revealing the past, but leaving the future open to interpretation. Most analysts, who swear by the profile, would probably stress that it is a tool — and a valuable one at that — since it can provide you with a pretty good idea of the kind of day that is emerging.

Sometimes the trading action can provide you with a good idea of what to expect — even without looking at the profile. Just recently, we had a buy signal in the minutes following the open. Within moments, however, the market was heading

lower and the losses were mounting. What to do? We promptly reversed positions and went short. But this didn't work either as the market suddenly screamed higher. Whipsawed!

On frustrating days like these, you have to back away from the market to gain some perspective. Sustaining two losses in a row, I was ready to take a break. But the price action didn't entirely surprise me. This day came on the heels of seven consecutive winning trades! Even after these two losers, I was seven for nine or 77 percent correct. Not bad.

Did I really think I would go nine for nine and be 100 percent correct? Hardly. I replenished my attitude by doing some errands, having lunch, and lingering over a Cuban cafe con leche. Only then did I return to my office in the afternoon ready to face the market with a clear head.

By early afternoon, the market had both rallied and declined some 250 points. This is what I call "market symmetry" — a perfect retracement of a prior move. The market, in essence, was back where it started from. Having killed both longs and shorts, the market was now ready for the afternoon trade. I bought it and caught a pure trend in the afternoon rally.

How did I know it was time to take a break and run errands?

If we assume that the early turmoil in the market will give way to a symmetrical pattern afterward, how do we know to wait until the pattern becomes evident?

In what situations does market "static" provide a genuine clue to market direction?

Are there patterns and trends which are identifiable?

In an era in which virtually all traders have access to key indicators, these are the questions that market analysts must answer in order to maintain a winning edge. We now turn to them in the next chapter.

TWO

Finding the Key Probabilities and Patterns

Traders who spend most of their time trying to analyze the market are often so preoccupied with their figures that they overlook the most obvious signals. This suggests to me that they are guilty of over-emphasizing their particular approach. The market will go where it wants to go. If we know what to look for, the signals will become much clearer.

Take, for example, the phenomenon of opening gaps. These are significant occurrences which appear frequently. The market opens significantly higher or lower away from the previous close, creating what I call an "opening gap." There are typically only two patterns which will occur following such an opening — either the market will recover and "close" the gap or it will continue, in which case the gap will remain.

Studies have shown that the day's high or low (but significantly, not both) will often occur during the first hour of trading. We'll look at some of the statistics proving this in a minute. Take this information and combine it with the ten-

dency of the opening gap to be filled and you have a point of view of the market which can be quite helpful. In short, if I know that prices tend to be at an extreme in the early going, doesn't it stand to reason that if I select the right side, I will have a relatively risk-free trade? As for playing the opening gap, one of two things will happen: one, if you "fade" the opening gap (buying on lower gaps and selling on higher gaps), the trade will often become profitable within minutes; or, two, it won't, suggesting it is no good. If it is no good, you can simply reverse direction and capture the trend.

CAPTURING THE MORNING TRADE

My strategy for capturing what I call the Morning Trade is so simple that it could be summed up in a single paragraph as follows:

The open is the key to market direction. Often, the market is taken down, creating a gap, providing an opportunity to buy the market with virtually no risk. The clue to knowing whether this strategy is correct is the immediate profits you will soon make as the market soars higher and the gap is filled. In a nutshell, if the market cannot break, it will rise. You need little market knowledge to "fade" opening gaps — only courage. If the trade isn't profitable within minutes, chances are you have the wrong side. You must exit immediately and reverse directions. The clue that this strategy is the correct one is profits. Is the trade making money?

What could be more straightforward?

Well, perhaps it is not quite this simple. The point is, you don't have a lot of time to act. You must be willing to react to situations quickly. Otherwise, the opportunities will cease to exist. The open, by most accounts, offers a unique opportunity that you don't want to miss. A market's recent price action is by far the most important indicator of current conditions, so that's where I begin my study of current conditions. Have you, for instance, just seen five or six consecutive higher closes? If this is a bull market, I want to be an aggressive buyer. The market will rarely, if ever, gap lower and break hard in this kind of a market. No. A bull market will only change direction after considerable market turmoil and after every last short in the world has thrown in the towel. So opening gaps, especially lower opening gaps, in this kind of market environment scream buy, buy, buy!

I want the probabilities on my side, so I can constantly try to size up the situation. What kind of market environment are we entering into? In short, until the market tells me that we are entering a significant new phase, I want my bias to be on the side of recent price action. This is the starting point of a leisurely analysis of the market — granted, a luxury you don't often have. In addition to a market bias — up, down, or sideways — I want to begin to quantify my analysis of market action. There are a variety of indicators that traders rely on to tell them whether the market is strong or weak. The real art of trading comes in when you can spot a strong divergence between indicators, suggesting momentary reversals prior to the price action becoming well known. Strong divergences are among the best signals you can have.

"TEST THE WATERS"

Since survival is my number one rule, I never want to risk ruin or serious losses on a trading error. So to refine my strategies, I will often "test the waters" on the open regardless of how I feel about the market. This means I will take a small position just to see how my positions are treated. I can always add to the position to pursue serious profits, or cut and run with a minimum of pain if I'm wrong. The point is, I want evidence — and to gain that evidence I often have to risk a little money to find out if my strategy is correct. (I find so-called "paper" trading totally worthless when it comes to analyzing the market. Unless my emotions are involved, I find the insights to be weak and not worthy of a serious financial commitment.) To me, not trading the market to gain insight into a day's activity is a little like flying a plane without leaving the runway; sure, you have to know what the instruments measure, but sooner or later you need to take off. When we get into a discussion of computer paper-records, you'll see that the actual in-the-market trading record becomes vitally important.

If the market is trending upward in a bull market environment and I get a down gap, so much the better. When the market opens steady to lower in a bull market, it is a gift which you must capitalize on. Down openings are simply the market's way to cleanse itself of weak hands. For the knowledgeable insiders, it is a way to frighten the longs into selling at fire sale prices. Since position traders are apt to have stops below the prior close, gap down openings create a momen-

tary selling panic which is soon met by aggressive buying.

What challenges a trader is not buying gap down openings, however. The real challenge occurs when the standard pattern goes awry, such as when you purchase the down gap only to see prices continue to deteriorate. Here you have to have the wit to exit the market promptly since the price action suggests something is wrong.

How do you size up such patterns? Simple. Time and price. Since the gap "should" be filled quickly, a failure to rally suggests one thing: the market is ripe for a sharp break. Moreover, you won't have to wait long for an answer. If a market gaps down and either dies or goes lower for more than five to ten minutes, chances are the selling is overcoming the buying. The market will break.

I try to judge whether a market honestly wants to rally or decline — whether, for example, the trade is working out in terms of both time and price. I clock the trade — entered, say, at 9:31 A.M. and then scrutinize the confirming indicators, TICK, Dow, Advancing vs. Declining issues, cash, and so on. After three to five minutes, I want to see all these indicators moving in a favorable direction. The market will typically begin to immediately move. But if I sense the market is struggling or is in trouble, I'm ready to jump ship before the real danger becomes known.

MONITOR THE MARKET

This market scrutiny requires intense concentration. Why

is the cash price, which is updated every minute, failing to respond? Does a lackluster Dow justify this opening? Are the bonds slipping lower or gaining strength? And, of course, you have to keep an eye on the futures price. I find that ten minutes is the outside limit on how long you can hold an unprofitable position right after the open. If the adversity continues after that point, chances are you have overstayed the market.

When it comes to pattern trading, you have to be careful to not make judgments based on yesterday's performance. Just because yesterday's market rewarded buyers of breaks, doesn't mean the market will prove likewise generous today. There's always the risk that the market won't repeat. Chances are, you have the best opportunity when the crowd gets caught in the conventional wisdom. That's when their panic will ensure your profit.

WHAT ARE THE PROBABILITIES?

As the computer era has progressed, more and more studies have been performed on pattern probabilities. For example, truly big days often require finding a trend and riding it through to its conclusion. This knowledge comes as no surprise; on an intuitive basis, I knew this to be true. But what do the computer studies reveal? Here are some findings:

1. The S&P makes the high or low 33% of the time in the first hour of the day.

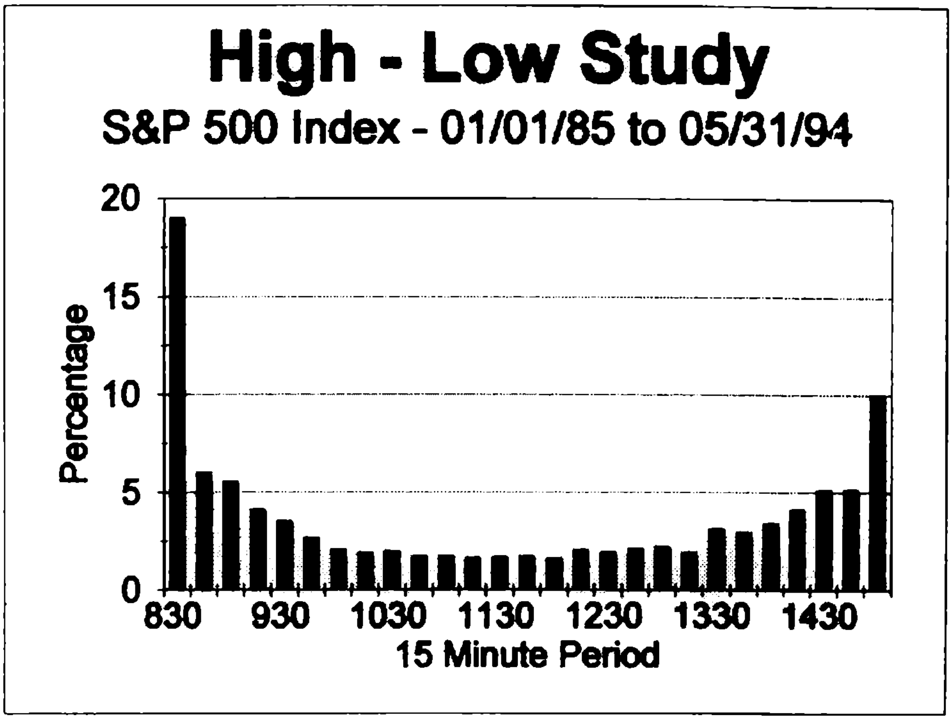
2. The S&P makes the high or low 33% of the time in the last hour and 45 minutes of the day.

3. This leaves four hours for the middle part of the trading day, resulting in the final 33%.

Our studies cover the period from the mid-Eighties to the mid-Nineties. Breaking the time periods down to 15-minute intervals (what the exchanges call "brackets"), the percentages grow even more impressive. In the first 15-minute interval following the opening of trading each morning in the S&P 500, the probabilities are 17-1/2% that either the high or low will be registered in that time bracket. This second closest bracket, in terms of percentages, where the high or low should occur is the final 15-minute bracket - where the probabilities are 10%. The only other 15-minutes brackets where the probabilities favor the high or low of the day occurring in a percentage greater than five percent is second, third, or final two brackets prior to the last 15-minute interval — in short, the first 45 minutes and the final 45 minutes. All the rest are less than five percent.

The illustration on the following page— the "High - Low Study" — shows exactly where the respective percentiles occur.

Taken on an anecdotal level, I know I can scroll back on my TradeStation charts and find this to be true. Just today, as I write this, the high and low respectively were 592.30 and 590.45. When did they occur? Let's see, the high occurred at 11:15 A.M. and the low at 3:40 PM. On the day prior to that,

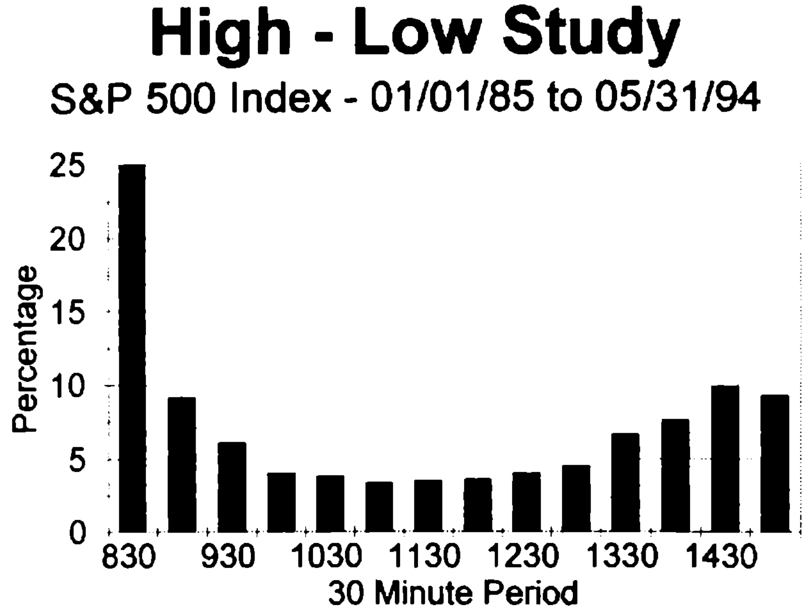


the low occurred at 12:05 P.M. and the high at 4:10 P.M. Prior to that, the times when the low and high were registered were 10:40 A.M. and 4:15 P.M. respectively. And on the day before that, the key times were 9:40 A.M. and 4:15 P.M. — the very first and last brackets. Remember, these are just days selected at random, and invariably the conclusion is the same: One end of the range tends to occur in the early or late going.

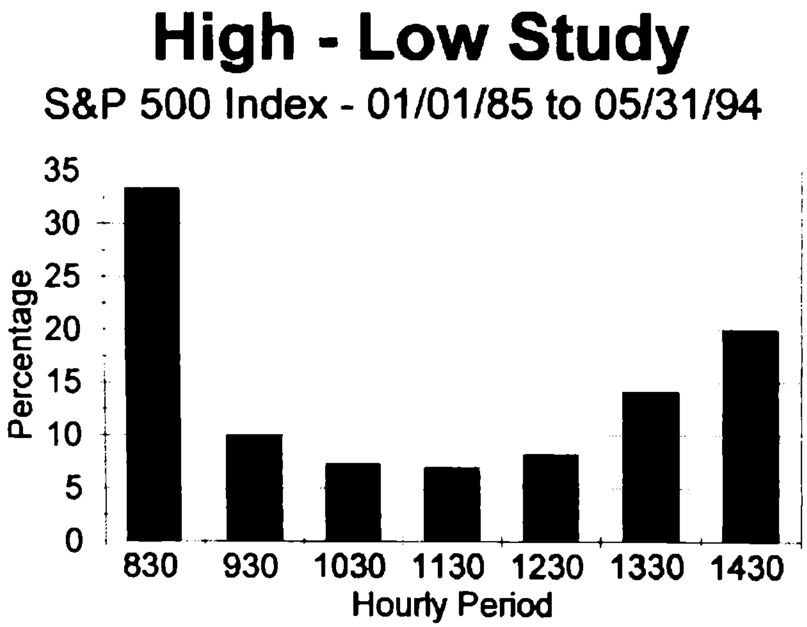
Now, when we look at 30-minute time intervals throughout the trading day, the statistics become even more compelling. Over an almost ten-year period, the high or low of the day was registered during the first 30 minutes of trading a substantial 25% of the time.

The illustration on the following page shows how one end of the range tends to occur in the first 30-minute trading interval. It also illustrates that the last hour and fifteen minutes accounts for at least one end of the range occurring some

27% of the time (please note that the last period labeled 1500 is only 15 minutes).



Lastly, when plotted on an hourly basis, the trend continues. You are likely to encounter the high or low of any given



trading day in the S&P 500 during the first hour of the day approximately one-third of the time.

I find the implications of these probability studies encouraging indeed. They tell me that if I catch a trend early in the day and the trade proves profitable, chances are I'm never going to experience any adversity on the position. Knowing this, I'm not afraid to a) add to my position in the early going or b) reverse direction in the early going. In the first instance, I'm interested in putting on a substantial base to capture the first favorable trend. In the second, I'm experiencing difficulties probably for good reason (I have the wrong side) and I'm eager to undo the damage by reversing positions. Sometimes knowing the percentages can give you the courage to trade aggressively.

FINDING THE DAY'S PATTERN

The optimal way to trade is to identify the day's pattern early in the day, to plot out an aggressive strategy to capitalize on that pattern, and to execute that strategy. While this is hardly an easy task, it helps to know what to look for. To loosen yourself up for the challenge ahead, you need to free up your thinking by engaging in some mental calisthenics. First, you have to understand that price movements have very little to do with underlying value and a lot to do with raw emotion and perception of the future. Let me illustrate this with a true story of a phone conversation I had with a clerk at my stock brokerage house five or six weeks ago.

Ring, ring, ring.

"XYZ Brokerage."

"Yes," I begin, "I'm interested in whatever information you have on the ABC stock. Do you have any earnings reports?"

"Let's see," the clerk says, tapping the symbol into the computer. "Here's the stock in my computer."

I hear him chuckle to himself.

"Yessir, this is a typical high-flier. Marginal revenues, no prospects, just a promising name. And it is selling at 70 times earnings."

The disgust in his voice was palpable. Here's a stock clerk passing judgment on what he perceives is a very poor investment.

I thank him and hang up.

Right away I know I have a winner. If even the lowliest stock clerk working the night shift at the XYZ brokerage house is down on this stock, it must be a winner. Then trading at $29 a share, the stock zoomed into the $150 range six weeks later.

This is a true story. If in the short term, earnings have nothing to do with the valuation of a stock, do you think the day-to-day fluctuations in the S&P 500 have a lot to do with the underlying value of the index? Hardly.

I call this notion — when the opposite to perceived events (the so-called "conventional wisdom") occur — the "paradoxical event." This frequently suggests that up is down, and that the very opposite will occur. That's why we frequently get down openings on hugely bullish days — and vice versa.

Did you know that on the day that the enormously successful "Windows 95" software was launched that Microsoft stock actually declined? It is the old story of buy the rumor, sell the news.

THE COUNTER-TREND OPENING

Once you are prepared for the unexpected, you'll be in a much better position to see what is really happening. Let's start, for example, with the opening. Did you ever have the misfortune to take a position overnight only to see your paper profits evaporate on the open? You are not alone. The counter-trend opening is the oldest phenomenon in the trading game —and, for its successful practitioners, one of the most profitable. Let's say it is Friday afternoon and the market makes a tremendous rally in the final 45 minutes, closing near the high of the day. There must be a reason, right? The whole world wanted to buy on the close. The shorts got killed. The bulls were in command. Just to be "safe," however, the enthusiastic bulls placed some sell-stops below the market. The thinking here is clear. Should the market decline on Monday morning, my stop will be hit and I'll exit having protected my profits. That's the theory.

Now, here's what actually happens. What looked so promising on Friday afternoon turns into a rout on Monday morning. The market slides through the protective "safe" sell-stop price like a hot knife through butter. All of Friday's hard-won profits are lost in the first 60 seconds of Monday's de-

bacle. The panic selling feeds upon itself and it takes a good 25 minutes of lower prices before the market stabilizes prior to a fast climb back up to — guess where? —Friday's close. This running of the stops has become more ritualized that the running of the bulls at Pamplona. Selling begets selling. Then the sophisticated "value buyers" enter the market and sanity returns as prices fill the opening gap. By then, the first real trend of the day has occurred. If you have missed it, perhaps you can capture the second trend which now slowly but inevitably retraces the entire break down to the morning lows and goes exactly two ticks lower before soaring back over 100 points in the final minutes of trading.

What has happened? Just the typical "perverse" market action that is so immensely profitable for those who understand what is going on. First, going overnight in the fast-paced S&P 500 futures market is a big mistake. I can always spot the novice trader by the duration of his trades and the number of different futures he wants to trade at the same time. In fact, there is an inverse relationship between the length and variety of futures contracts one trades and the likelihood of success. The new guy, who thinks he is well capitalized with ten grand in his account, is likely to have a couple of currency contracts, a soybean contract, perhaps a heating oil contract, and is trading the S&P. He's also probably waiting for the "freeze play" in frozen concentrated orange juice futures. The professional, on the other hand, is a specialist within a specialty. Chances are, he's a bond scalper or he spreads the back months in the Swiss. Or he's a short-term S&P local. But you can bet he's not trading in three or four markets at a

time. Just as in the medical profession, futures trading is a specialty. You cannot be expert outside your field. So learn to do one thing well.

My specialty is short-term aggressive day-trading. There are a variety of reasons why I favor this approach, but the overwhelming one is that it ideally suits my temperament. Granted, there are arguments you can make for any number of market strategies. But the bottom-line argument, in my opinion, must always be one of risk versus reward. I've seen too many people go broke trying to make a killing.

As a day trader, you must learn to be nimble and quick-footed if you are to succeed. The open, as I've mentioned, is often a time of great opportunity if you are aware of what is really going on. There are two things you want to take into consideration in trying to size up the day's pattern: one, where has the market come from; and, two, where is it likely to go.

When you have strong bullish days with the low occurring early in the day and the high in the final ten or fifteen minutes, the market is trying to tell you something. It wants to go higher. But knowing this simple fact and making money are different. Ask yourself: what is the opening going to be like following a big up day? Chances are you are going to get a gap up. Why? Because there is carry-through overnight. There are a few stops above the market. They will be cleaned out on the opening gap. Also, it creates a great selling opportunity for those in the know. So what you will see, following a big up day, is a gap up and higher prices — momentarily! Then the market will be slammed lower, often falling 200 points in 15 minutes.

INTRA-DAY HIGHS AND LOWS BECOME STOP-RUNNING

But this is simply the opening volley. The new intra-day high, created in the initial ten minutes, is now a new target as the market heads for the old highs. Sure enough, with time, those highs are taken out — by two ticks. Then the markets plummets lower and go two ticks under the intra-day low. Then up again. What is happening? The market often becomes wobbly following a big up day. It needs a rest. And it demonstrates this tendency to want to gyrate by the price action in the early going.

There are two, sometimes three, good trends a day. The first often occurs in the first ten minutes of trading, often on a gap. This move is often a good "trade," meaning you can take a position opposite to the trend and win. The second is also a morning trade. By now, you are typically 20 or 30 minutes into the trading day and the first real trend is about to emerge. But don't grow too confident. This trend typically lasts just an hour to an hour and fifteen minutes. The late morning and lunch hours (from noon to 2:00 P.M. East Coast time) are typically the slow trendless times of the day. But, again, in the afternoon, you can often capture a trend into the closing bell. This is when the serious money is made.

The opening is the clue to the day's pattern, and you can often make some good judgments based on the market's behavior in the early going. I like to see the market pulled "out-of-line" on the open because it means a corresponding counter-trend is often not far behind.

For years, the smart money in the U.S. Treasury Bond futures market routinely "faded" these out-of-line openings with stunning success. But then due to a variety of factors — the introduction of the night session, the new opening time, and the introduction of new sophisticated computer pricing programs — the market changed. With large banks bidding and asking thousands of contracts at every tick, the market became more mature and much, much harder to beat. In the stock index futures market, however, you still get these market aberrations which can be routinely faded, often successfully.

Unfortunately, even knowing that the open is apt to be the clue to the day's eventual trading pattern, it would be incorrect to suggest that you can always fade an opening gap. The percentages may favor this approach, but the market is far too complex to suggest that such a rigid rule would work under every circumstance. I am reminded of just such a circumstance not long ago. The market gapped open higher, setting up a solid selling opportunity. I immediately sold some contracts. That's when I noticed that something was wrong. Instead of declining virtually immediately, the market started to move sideways. There was plenty of buying and selling going on. But neither side was winning the battle. Five, ten minutes passed. I wasn't really losing on the short contracts, but I certainly wasn't winning. Something was wrong.

Recognizing this, I grabbed the phone and bought back the short positions and went long.

When I saw that I was paying up for these contracts, I knew I was correct. The market soared higher.

TIME WILL IMPACT ON PRICE

It is the old story about time and price. When the time is right, the price will occur. In this instance, too much time had passed without price movement in the "proper" direction. By that, I mean down. It should break quickly on an opening gap. When it doesn't, you must rethink your strategies.

In sizing up the day, you must remain flexible. Any sort of inflexible approach to the market is doomed to failure. Let's take, for example, the intra-day highs and lows. Going into the day, you have no idea where these levels will occur. They are important because they become the focal points for the stops. This, in turn, sets up a scenario where the stops are gunned at precise price levels which were totally unknown prior to the creation of the intra-day highs and lows. When looked at in this light, you can appreciate why it is so difficult to make a reasonable analysis prior to the opening bell. You don't know if the market is going to gap higher or lower — or, indeed, open unchanged. Each opening suggests a different approach to capturing the early morning trends.

The tendency among many would-be successful analysts is to want to quantify price action, assigning numbers whenever possible to explain market action. I understand this yearning, the need to make the art of trading a rigorous science, but I suspect it leaves something out. For one, the approach is simply too pat. You cannot assign a number to a given market phenomenon and then treat it as if it were written in stone. I recently had a reader of one of my books call and explain why he'd lost money. In my development of the LSS 3-day

Cycle Method, I'd discussed a three-day pattern. On day one, a buy day, you would buy a steady to lower opening for a rally; on day two, you would look for the market to stabilize or rise slightly. And on day three, an early morning price rise would generate an opportunity to sell prior to a price break, again resulting in profits. This, at least, was the theory. But in reality, there were days when the pattern didn't appear, or it had to be pushed ahead a day. So how did my reader lose money? He took the explanation to mean he could simply buy every three days. Needless to say, it didn't work.

Having dispelled that notion, let me say that there is a place for serious numbers crunchers. In my LSS 3-day Cycle Method, I make no less than four support level readings and four resistance level readings every day — and then I average these numbers for yet a fifth reading. These numbers create what I call the buy and sell envelopes. You'd be surprised how accurate these numbers can be over a long period of time, especially in non-trending markets.

Moreover, LSS generates numbers that help predict the day's range. Taken over a long period of time, these numbers have proved remarkably accurate. In fact, the LSS software has a charting feature that allows you to view (and print) the day's actual range right alongside the anticipated range. Utilizing these numbers has a powerful impact on your ability to trade successfully. This is because you are playing the percentages day in and day out. By taking all these measurements in a quantitative approach to the market, you are saying, in effect, the market should find support here and it should find resistance there. When it does, it provides you with the

confidence to trade correctly; and when the support and resistance levels are violated, it tells you something is out-of-line, maybe the market will now trend to a completely new price level.

My point: numbers are essential, but they are not the entire answer. Futures trading is an exceptionally difficult game, and anyone who plays it must accept the fact that the answers are not all in the numbers. For those of us who are serious students of the market, this means we must understand that the market will be influenced by a wide variety of factors, many of them contradictory and often misleading. Instead, we must learn to analyze the most recent price action and try to arrive at some conclusion about why the market is behaving in one manner or another. Take, for instance, these days when the range exceeds over 1,000 points. Such days used to be extremely rare. But now we are seeing them on a regular basis.

Following such incredible price action, you often get a day when the market is simply exhausted.

You have a low-range, inside day with very little significant price action. On such days, the market simply needs a rest for a day or two to absorb the enthusiasm of the high-flying price activity.

I find this explanation quite satisfying. Because typically, after a day or two, the original trend reasserts itself. If the market has been moving up nicely prior to the turmoil of a high-range day, things should settle down in a day or two and the buyers step in again. Remember, there are always those investors who are expecting the worst at all times. At the

first sign of trouble, they panic. This creates additional selling. And before you know it, you have some serious breaks. When this happens simply ask yourself whether the panic was justified? Was this trend truly coming to an end? Was the move overdone? Perhaps a news event served as a peg upon which to hang bearish news. Traders on the floor in Chicago often wear buttons that proclaim in large letters, "DON'T PANIC!" But when you think about it, panic, both large and small, is what the game is all about. If I can keep the guy on the other side of my trade panicked and scared to death, chances are I'm going to beat him — or, more accurately, he's going to beat himself. "Intimidation," a floor trader once explained to me years ago. "That's what this game is all about."

Finding the day's pattern is always a challenge, but I always try to plot out a scenario anyway. Will it be an up day? Down day? Sideways? These are helpful terms, but not as helpful as trying to understanding how the market will rise or fall. The task becomes more manageable once you have some numbers to work with — buy and sell numbers, for example, or envelopes such as we use in LSS. These numbers tell me where the market will trade within a high probability. The pattern — up first, sideways and down, or whatever — is the key to your trading success, however, because timing is everything. If the market is going up today, but not until they kill every last long who ever existed, you aren't going to have success buying the opening. No. Rather, you need the flexible approach that permits you to begin your buying judiciously late in the afternoon when the real trend kicks in. How

do you know this? By continuing to study and analyze the market you are trading. And asking yourself important questions: What does this break mean? When they got the stops on that last break did the market come back — or did the bottom fall out? What time is it?

Given the chaos of the market, it isn't hard to grow disenchanted in trying to ascertain the day's trend. But the situation becomes more manageable once you break down the day's trend into three broad categories: time, price, and trend. By "trend" I mean the day's intra-day trend and trying to figure out if the last mini-panic or bounce has run its course. If we understand that time and price are everything and there are only so many patterns that play themselves out over and over again, chances are we can come to a pretty good conclusion concerning the next thirty or sixty minutes of price activity.

MORE PATTERNS

There are five or six key trading patterns that tend to repeat, given a few variations, endlessly. My approach is to try to map out the pattern — up in the morning, back down in the afternoon, for example — and only then try to assign numbers to what I'm looking at. So much depends on how the market actually behaves once it opens, however, that you can virtually throw out a given scenario if you don't see the pattern emerging as anticipated. It is for precisely this reason that my LSS system identifies not one or two potential trades

per day, but rather four or five. And they are almost exclusively based on a given contingency occurring. For example, if the market opens higher and trades up to Level A and retreats to Level B, well now you have one signal. Another might deal with a lower opening. And yet another with adding to the first position with a second position. Of course, given the need for flexibility, we also try to identify those days when the trend is so overwhelming we simply want to buy or sell the open regardless of price.

Pattern identification is endlessly fascinating. And the more work I do with trying to find the patterns, the more convinced I am that a market symmetry exists. Take the stair-step pattern that so often occurs. In many homes you will find stairs with perhaps five or six steps up to a level landing. At that point, to save space, the stairs may reverse direction and you will have another five or six steps up to the home's second level. There is a clear symmetrical pattern in this kind of construction and I find the same pattern exists in the market. The first time someone pointed this out to me, I couldn't believe what I was seeing. There would be a rise in the market (comparable to the first tier of stairs) followed by a sideways action (an equilibrium level). Then, after an appropriate amount of time had passed, there would be a comparable rise. Step up, sideways, step up.

What I was finding was that this pattern wasn't haphazard. Just as the stairway wouldn't go five steps up to the landing and then another 15 to the second floor, the market wouldn't rise in this fashion either. Rather, it rose in precise symmetrical fashion. One-hundred points to the first level,

sideways, and then another one hundred points to the top — precisely. And I'm not talking about a general pattern either. After considerable research, I found that I could often identify the top tick well in advance of its occurrence!

TIME AND PRICE SYMMETRY

Students of technical analysis may be familiar with this chart pattern — the "measured move." So much up (or down), sideways, and a comparable move. When identified on good technical software programs, such as Omega Research's "TradeStation", the results are encouraging indeed. In the S&P 500, I find that one-minute charts with easy-to-read closing ticks are the best way to identify this, among other, patterns. I simply wait for the market to tell me where it wants to go. Then I look for the sideways action or what I call the "equilibrium level." Then, in anticipation of the next leg, I begin measuring with one of the TradeStation support and resistance lines. With a few commands on the computer, I then identify where the market should go — to the precise tick. I cannot tell you how exciting it is to see this number hit time after time. Speaking of time, because time and price is everything in trading, the price alone is not the entire payoff. You can even pinpoint the time when the move should exhaust itself at the top, signalling the correct time to sell.

Let me tell you the criticism I've encountered from those few individuals I've discussed this with. The most common comment is, "Well, you missed half the move. Why didn't

you see this rally coming in advance?" These people are looking for crystal ball readers. And, believe me, they will find them out there somewhere. There is no shortage of experts in the futures markets these days. But what I'm talking about is making money — consistently, day after day, with low risk.

LEARN TO IDENTIFY THE PATTERN

Up-sideways-up — that's one pattern I've identified to my own satisfaction, but it works equally well on the downside when you have a down-sideways-down pattern. There are a number of variations on these for sure, depending on how large or small a scale you look for. But in general these patterns are consistent and not hard to identify.

The complexity of the market will overwhelm you unless you know specifically what to look for and how best to use the information to trade effectively. Let's start with the easy part and move up to more complicated questions. First, I say with almost one-hundred percent certainty that the market will probably move at least a given number of points on any one trading day. You need to know your market to make an accurate forecast of this number. Back in the mid-Eighties the bonds were good for probably a basis point or more everyday, but then in the late Eighties, with the taming of inflation, bond ranges sharply declined and the average range probably was only half that amount. At any rate, you should know your market. So you'll know what to expect in terms of the range.

Now the pattern is another matter entirely. There are variations on perhaps a half dozen primary patterns, and the tendency is to want to become overly mathematical about things and attribute numbers and dictums to certain price behavior. And unless you simply want to rely on guesswork, you are probably better off trying to merge the intuitive with an analysis of the numbers. One way to approach this task is with the mentality that you don't know, you don't much care, and you are in need of enlightenment on the subject of today's price action. The reason I say this is because you want to approach the market fresh with a sort of blank slate before you. By doing so, you are giving up your cherished "opinions" which, not surprisingly, often become the bane of most traders' existence. You take the ego out of your trading, allowing the truth to filter in. This, by the way, is not an easy state of mind to master.

In sizing up the day's pattern, you need to look at the prior day. Did prices begin low and close high? Did prices begin near the day's high and trend lower? Or was it one of those lackadaisical affairs when prices simply meandered back and forth throughout the trading session? Yesterday's price action will definitely have an impact on today's price action. To best understand pattern cycles, you need to consider George Douglass Taylor's "Book Method" upon which the LSS 3-day Cycle Method is based. In a nutshell, Taylor claimed that the market was "engineered" from within. Essentially, he discovered the paradoxical event when he suggested that the market is taken down in order to go up and taken up in order to go down — the very reverse of what the conventional wis-

dom would think. Moreover, he said there was a three-day cycle — a Buy Day, a Sell Day, and a Short Sell Day. While this simplifies matters somewhat, it creates a workable theory which is frequently borne out by market action. The important thing to remember is that the typical pattern means lower prices following the open prior to a rise. A second day when prices struggle higher. And yet a third day when the market goes into new high ground just long enough to get everyone bullish — then, naturally, the bottom falls out.

As a result, the hapless trend followers inevitably give all their money to those who have figured out this pattern. Trend followers almost always find themselves at a disadvantage, even when their analysis of the market is often accurate. For instance, the market may be entering into a bull phase. But they buy on the third day up — right when the market is about to be slammed lower. The point is, the buying opportunity will then exist on the following day on a lower opening. The beneficiaries of this knowledge, of course, will be those astute traders who are buying when the crowd is selling on stops and emotion at the lows on the Buy Day. In order to convince yourself that this precise scenario occurs with some regularity, you only have to monitor price action on those days following the Short Sale Day high-to-low pattern. What typically happens? The market opens lower, often taking out stops, trades lower and finally stabilizes and rallies, closing on the high of the day.

The buyers on such occasions don't always get the best of it, especially in the early going. But given sufficient time and the persistence and intelligence to buy more on the breaks,

the buyers frequently emerge the winners. The market is often populated by those who can't resist the temptation to make some easy money. Selling the lows, however, on a day when the market has already given up significant ground on the prior day is not a good idea — only a popular one. Remember, the pain factor is also operating here. Until all the sell stops are filled, the bottom pickers will be vulnerable and their selling is what is driving the market lower. In time, however, the lows of the day will often be registered and there is but one way the market will go — higher.

The crowd mentality, which tends to feed on itself, often prevails at the open. Because the crowd is in a rush to sell is no reason for you to join in their emotionalism. After all, someone is buying the market, even if prices are trending lower. Typically, these are the knowledgeable insiders who are able to capitalize on this particular strategy. Indeed, it is not unknown for the big traders to spook the pit by pretending to offer large quantities of contracts that they know no one will "hit." Of course, every bid and offer is legitimate in the sense that if a fellow floor trader agrees to "hit" the bid or offer, they have a trade. But when the big floor local starts offering hundreds of contracts in a falling market, no one is likely to stand up to him. Rather, the smaller traders will join in the selling, thinking they now have proof that selling is the right idea. That's when the former phantom sellers suddenly become serious, legitimate buyers, often buying everything in sight. This is why you suddenly get those fast market rallies. The pit has been caught unawares and now they have to scramble to buy back their contracts at any price just to get out.

WHERE DO YOU GET IN?

Frequently, the run off the lows will be devastatingly fast. This is the sign that the market has reversed and you now have to think about buying. But you cannot simply join in the rush to purchase contracts lest you buy the top. Rather, wait for some sanity to enter the market. That's the time to buy. Fortunately, there is often time to think through your strategy. The fast rally off the lows may take 10 to 35 minutes. At that point, selling will inevitably enter the market as the winners seek to take profits. After the profit-taking setback a period of equilibrium will set in. This is when you can begin to measure the rally from low to high. Let's say the rally was good for 150 points. Now, with the sideways trend creating an equilibrium price, you can begin to measure from the low of the equilibrium price to where the market might go, the anticipated high. What number do you work with? That's right. The 150 point rally. That's 150 up, sideways, and another 150 to the top. You can often predict this price to the tick!

Does the market always reach this anticipated price? Of course not. Sometimes the second leg fails. Significantly, you occasionally get a pattern where the market retreats back where it came from. Yet, in this scenario, the time and price patterns likewise tend to hold. Indeed, the retracement is often a mirror image of the rally. Up 150 points, sideways, and then down 150 points — right to the precise tick at the low.

In 1995, I wrote a seminar manual for a series of lectures I was giving on day trading.

In researching these time and price patterns I looked at the most recent 5-minute charts on my TradeStation. The morning and afternoon trends were often mirror images of one another. In the morning, you would have 180 points straight up followed by the lunchtime counter-trend down. Then, in the afternoon, you would have another rally, this time 185 points. How much closer could you get? Moreover, the time intervals would often be related. On the morning trade, the rally might persist, say, 45 minutes. And on the afternoon trade, the rally might persist 50 minutes. Again, we are talking about one bar on a five-minute basis. With additional studies, I began to observe another phenomenon. The speed with which the price action would take place would often double as you approached the end of the trading session. What often took an hour to accomplish in the morning, would occur in just 30 minutes later in the afternoon.

The notion of the "first shall be last and the last shall be first," which is Biblical in its origins, gets played out again and again in the futures markets. The early morning buyer, who buys the breakout after the open, often finds himself sitting on losses with nowhere to go once the early enthusiasm gives way to selling. The initial trend is often a false trend just as Taylor suggested. When the market develops in such a predictable fashion, many of the patterns will easily become identifiable.

There is no magic formula for interpreting every pattern since so many are similar in appearance in the early going. For this reason, you must monitor the market and be prepared to switch strategies as soon as the anticipated pattern

fails to emerge. For example, one of my favorite trades is to "fade" a gap immediately following the open, selling up gaps and buying down gaps. With these patterns, you should know almost immediately whether you have the right side. Once the market fails to perform as expected, you must remain flexible enough to switch sides and go with the new trend. The successful market analyst must remain constantly aware that the probabilities favor those who act quickly and without hesitation. The market will sort out the winners and losers in due time.

We have already discussed the likelihood of one end of the range being established if not on the open, at least in the early minutes of the trading session. When you add to this the end of follow through, you have an added tool to help you trade. What do I mean by "follow through"? Simply that there will be a continuation of the price activity from the previous day's close. For instance, if the market closed strong yesterday, chances are you will have a strong open today. Typically, you even get a gap up open, which is often the best selling point of the day. This is why I routinely sell up gaps. If I am wrong, I can add to the position, averaging in a higher selling price, as the market rises. But one thing is certain: I'm going to have a decision, one way or the other, quickly, often within five or ten minutes. Rarely will the market gap open and stay there. If it does, it almost always goes higher. And, of course, if it doesn't stay there, it frequently declines, resulting in profits for the short sellers. After a typical higher gap opening, the market will often start to decline in earnest. You can often get a quick 200 points in the first hour. Then,

with any luck, you can await the afternoon decline where you can grab another 200 points. Given the time of day, you can make the comparable amount of money in half the time, or 30 minutes.

Patterns repeat in both time and price. This tends to be true even on non-trending days when you have to ride the trend back the other way from which it came.

MEASURE, MEASURE, MEASURE

Taylor's enthusiasm for measuring the market in his "Book Method" gave me the idea for tracking patterns on an intraday basis in recent years. After all, if markets tend to rise and fall in predictable patterns and magnitudes over a period of time measured by days, wouldn't it make sense to do intraday measurements as well? This reasoning led me to analyze price moves in terms of both time and price. Significantly, my studies proved to me what I already knew. Most of the money is made on key moves of comparatively short duration. Prior to understanding this phenomenon in such a profound way, I was the traditional position trader during the day. I wanted to sell the high of the day at the open and buy back the low of the day in the afternoon. If the market had a 400-point range day, I wanted to win 375 of those points. In the parlance of baseball, I wanted a "grand slam" every day. Oddly enough, I was occasionally able to accomplish this somewhat ambitious goal. But in the long run, it was a mistake. Most of the time, the market isn't going to give you the

day when the really big profit is available. That means there was a lot of wasted effort chasing an impossible goal. The best explanation I ever heard concerning this went as follows: "All I'm trying to do," a winning trader told me once, "is make money."

With this is mind, I began to measure moves during the day and noted when they occurred. The conclusion is deceptively simple. There are two moves a day — one in the morning and one in the afternoon — and they tend to be anywhere from twenty minutes to maybe an hour or an hour-and-a-half long. The rest of the time the market is simply setting itself up to move. If you can capitalize on one or both of these daily trends, you can make a lot of money.

As a general rule, the day's market pattern is determined by how traders perceive the news. A news event can be overrated, underrated, or simply ignored by the market. Regardless of how the market reacts to the news, the important point is not the news event itself but rather the perception of the news. Here the market psychology is the important factor, not the reality of the situation. There are many ways to interpret the market's reaction to news. It was already discounted in the market, a leading stock had strong or weak earnings which influenced the averages on that day, interest rate jitters, comments of the Fed chairman, and so on. Indeed, this is what makes a fundamental analysis of the market so difficult. If market psychology is the overwhelming factor in determining market direction, why struggle to understand the fundamentals?

This is the reason that technical analysts stress factors

that often ignore the fundamentals. Far more important, in my opinion, is the price action itself, and the market pattern. You can anticipate these patterns all you wish. But market action must ultimately determine your reaction to market behavior. On a day when I anticipate lower prices, a strong market will cause me to rethink my strategy 180 degrees. There is nothing wrong with simply being wrong about the market as long as you don't become stubborn about your opinions. So whereas I might have wanted to be a seller yesterday on a lower opening, in the face of contrary market action, I might want to buy a higher open tomorrow. After all, the market is going to go where it wants to go. Your reaction to market behavior must be one of following the least resistance.

When you approach the day's first trade, you want to do so with a knowledge of yesterday's pattern (where has the market been?) and an idea of where the market is apt to go. You may have the up-sideways-up pattern, in which the two up legs are comparable in magnitude and perhaps duration. Or you might have the down-sideways-down pattern, in which you have the mirror image. Likewise, the initial up pattern might be entirely cancelled by an afternoon market that takes back the ground. An illustration of this might be an up-sideways-down pattern, in which the up and down legs are of comparable magnitude. Of course, you might also have the mirror image of this in a down-sideways-up pattern.

These are familiar patterns. More rare are the true trending days, when the market opens at the low of the day and closes on the high; or, of course, the reverse, when the market opens at the high and closes on the low. These true trending day

patterns, while somewhat rare, are among the most profitable patterns you will ever encounter. Staying with the position, however, and even adding, requires a steadfastness in discipline.

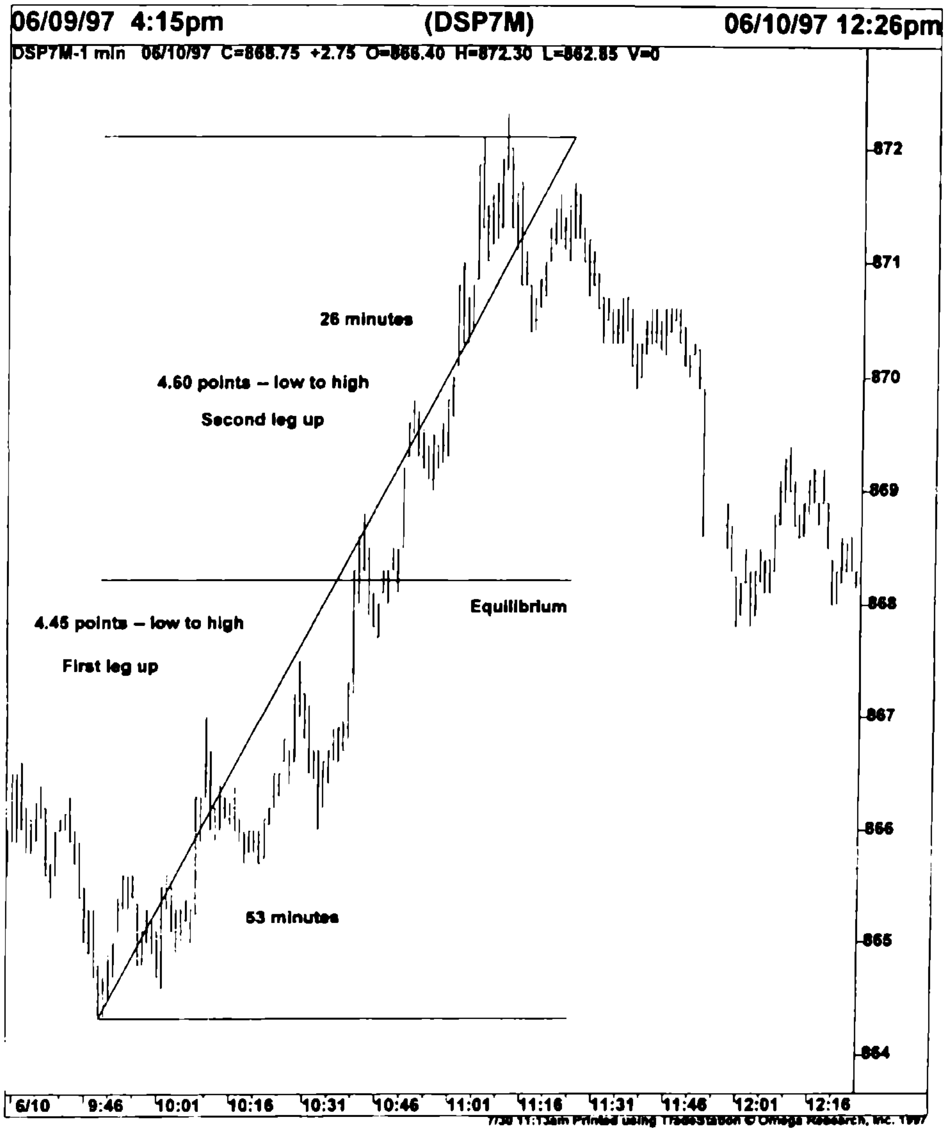


Chart #4: Prices tend to rise and fall in two distinct comparable legs, separated by an equilibrium level. While the price ranges tend to be similar, the velocity often increases by a factor of 2. Hence, the 53-minute rally in the first leg is followed by a 26-minute rally on the second leg. A second leg that fails to equal the first in magnitude suggests a price reversal – at least temporarily.

TWO APPROACHES

There are two ways to analyze the first morning trade. You can anticipate the move based on market probabilities (yesterday's price pattern was low-to-high so we are likely to see the high made first today), or you can wait for the first move, wait for the counter-trend and go with the initial trend. Both are legitimate strategies. Both have their own risks. As an alternative, you can let the morning action serve as a prelude to your afternoon trade. When the market has had a big move in the morning, traders will eagerly await the opportunity to grab a similar opportunity in the afternoon. There are many reasons why you often get a continuation in the afternoon, not the least being that major fund managers (in the case of the stock market which drives the S&P's) may have regretted missing the morning move. The herd mentality plays a role. Then, again, the morning short sellers may have missed an opportunity to take profits over the lunch hour. Their buying panic will also certainly drive the market higher as the market approaches the close. And, of course, you will have the speeding up of the price action as the leisurely pace of the morning gives way to the frantic emotionalism of the afternoon. Given the perverse nature of the futures markets, one must always be aware of the counter-trend pattern no matter how short-lived. One common phenomenon is a final lunge into new high- or low-ground just prior to launching the afternoon's real trend. I call this "price rejection" and it is a virtual everyday occurrence. Just remember, the market will attempt to fool or confuse as many participants as possible.

Only then will it be free to mount a genuine trend, either up or down.

THE IDEAL ENTRY PATTERN

In looking for the signal to enter a position, you want to look for a pattern which suggests a high may have just been made (the sell signal) or a low has just been made (the buy signal). While we are not attempting to pinpoint the exact high or low of a move, we are looking for good signals which will result in profitable trades.

To identify the sell-pattern signal track the market at one- five- and even ten-minute intervals and make note of the closing prices. Obviously, this is most easily accomplished using a software program that creates bar charts, but anyone can track the market with a simple watch with a second-hand timer. The sell pattern is up, down, down. This means a higher price followed by two lower prices. The third reading may also be the same price as the previous price but it may not be a higher price.

The buy-pattern signal is the mirror image of the sell pattern — down, up, up. This means you want a lower price followed by two higher prices. Again, the third reading can be identical to the second, but it cannot be lower. This invalidates the signal.

Look through price charts and you'll begin to see these top-and-bottom formations. You'll find that even small price counter-trends are characterized by small spikes in price, sig-

naling a temporary change in trend.

To have confidence in these signals, it is important to know why they occur. The answer has to do with price rejection. The very best prices — the highs and lows of the day — are incredible opportunities for the traders who are fortunate enough to get them on the right side. For this reason, their existence is short-lived. The market is typically "out-of-balance" on these price spikes and often returns to equilibrium — the price where buyers and sellers are in agreement. Thus, a market may trade in the middle of its price range for, say, 85 percent of the trading day, but the extremes in price represent only a fraction of the trading activity. Anyone familiar with the bell curve of a typical non-trending day in the Market Profile studies will attest to the validity of this observation. Major daily tops and bottoms are almost always characterized by sharp price spikes. This is the point where prices move quickly and are just as quickly rejected.

EXIT STRATEGIES

The correct time to exit your position is when the move is exhausted. You will know this both by taking constant measurements, in which case you can anticipate the top or bottom, or by simply looking at the price action, which will often conclusively show when you have missed the move. Remember, tops and bottoms are made quickly. The market rarely spends a lot of time at the extremes of the day. For you to capitalize on these short-lived opportunities to buy and sell

at the day's very best prices, you must be prepared to take action before the prices are actually reached. My favorite strategy is to make the market "reach" for my order. Thus, if I am long and the market is trending higher, I will have a limit order to sell at my price above the market where I think it will stop, or, at the very least, at a resistance area. By following this strategy, you always run the risk of getting out prematurely. But far more often, this reasoned exit approach provides you with a highly satisfying fill.

How do you decide where to get out? Time and price. First, let's look at time from two perspectives. One, is the time of day. We know from our studies that the market often reaches an extreme on the day (top or bottom) in the final hour of trading. Not always, of course, but these are the probabilities. Moreover, there is another consideration. As a day trader, you don't want to exit the market later than the day's close. For sure, there are markets where the high of the day is reached in the final seconds. This is where the MOC order, which I strongly endorse, is the best possible order. But, more often than not, you are looking at that price extreme to occur sometime during the final trading hour — perhaps 3:15 P.M. East Coast Time, perhaps 4:00 P.M or even 4:05 P.M. You never know for certain. Two, trends occur in legs. Often there are two, occasionally three. By measuring the duration of the first leg, you can make an estimate of the duration of the second, and often final, leg. For example, I'm looking at a 5-minute price chart in which the S&P's trended higher for exactly nine bars, or 45 minutes. The bottom was made at 1:15 PM. and the top at two o'clock. That's the first leg of the

trend. This was followed by approximately 12 bars of sideways action, during which an equilibrium level was established. This amounts to one hour. It is now three o'clock and we are about to enter the final hour of trading when the extreme of the day should be reached.

We have nine bars up and 12 bars sideways. As the price begins to soar up above the equilibrium level (which has been confirmed as a value price over the past hour of sideways price action), we can buy the market and count ahead 9 bars, or 45 minutes. This is where the market should exhaust itself in terms of time. Sure enough, this is right on the money. The high of the day is made precisely at 3:45 P.M.

Now let's look at price. There is a symmetry in the market. Legs tend to mirror one another. Accordingly, if leg A is equal to 100 points in value, chances are leg B will equal 100 points in value. Rare is the situation where you have, say, a 200-point move followed by a 500-point move. Rather, the legs tend to be similar. For argument's sake, therefore, let's say the first leg is equal to 100 points. After the equilibrium point is established in the sideways phase, chances are you will have another 100-point move. So where do you place your target sell limit order? Exactly 100 points above the equilibrium point. That's where the market should go. You'd be surprised how often this simple strategy works.

There are, of course, variations of this theme. As mentioned earlier, the second leg is often made faster than the first leg. In either case, the price objective should be reached. Moreover, you will occasionally have rallies where the market, driven by emotion and stop-running, will take out the

price objective and soar higher — at least temporarily. Don't take this as a sign to begin buying again. Typically, this is just panicked short-covering and the market has indeed exhausted itself. When this occurs, it is easy to spot. The top is made quickly and the close on the 5-minute bar is at or close to the bottom of the bar. As additional evidence, the market will never trade higher after that. If you have overstayed the market, you must get out immediately. Chances are, the top has been made and it isn't going back to the highs. Where will it then likely go? Back to the middle, to the equilibrium level. This will often occur because the rush of bullish traders to take profits will drive the market lower into the close.

Once the market exhausts itself in this fashion and you conclude the "party's over," you will have a much better appreciation of what a trend means. You cannot force the market. You must learn to take what it gives and capitalize on trends the best you can. If you miss this afternoon trade, simply wait for the next opportunity which will occur, no doubt, the following morning. You can develop a strong sense of knowing exactly what you are looking for in terms of trends and then jump on them. This is the only satisfying and profitable way to day trade.

THE REVERSAL TRADE

When I analyze a trade, I normally look first at how the market is behaving; I like to buy or sell shortly after the open, especially on gap openings. But when the gaps fail to close

as the probabilities suggest they will, I am quick to reverse directions, first by exiting the initial trade and then by taking a position going the other way. To work properly, this switching of sides must often be accomplished quickly, often moments after the initial entry if the opportunity is to be seized. Over the years, my programmers and I have tinkered with reversal techniques that have either proved promising or reckless. I have concluded that reversing does indeed work, and is often the key to a profitable day when properly executed. But it most certainly cannot be used in every trade under every circumstance by any means.

I pay attention to price behavior shortly after the open because that's when the first trend should occur. Typically, it pays to sell rallies or purchase dips at this time of the day, since the initial counter-trend tends to offer a good opportunity. If, in the past, the morning's rallies and declines have proven to be short-lived in nature, it demonstrates the validity of this approach. The problem is the exceptional day when the opening rally is the beginning of a legitimate day-long rally. Then what do you do? The answer is to reverse direction.

The reversal trade, by definition, occurs when the first entry has resulted in losses and you are reversing direction in the market. Psychologically speaking, you are already sustaining losses and, typically, the day's session may be only moments old. Paradoxically, these reversal days tend to offer some of the best profits because you are doing the right thing in the proper fashion, aggressively trading the market. And you are often richly rewarded.

REVERSAL RULES

When is the reversal strategy most likely to succeed? When the market is likely to trend, which, as we discussed, is often in the first hour, shortly after the open, or the final hour just prior to the close. This is because the market rarely goes dead shortly after the open. To my dictum about taking the reversal trade quickly, I offer these suggestions: One, you must reverse on a market order — not a limit order. There simply isn't time to pick your price. I once had a client who insisted on getting back in on a limit order. By insisting on his fill, he had to settle for nothing when the market soared out of sight. He ruined a perfectly good and profitable strategy by insisting on a price. Two, you must reverse without hesitation. When the market is ready to run, the window of opportunity may be a minute or less. You simply don't have time to watch the market for a while. A corollary of this rule is that you cannot let previous losses influence your ability to reverse. Three, in deciding to reverse, you must watch the market carefully. There are often definite signs that the market is ready to run. Four, you must identify the market conditions before you reverse. If you reverse on a non-trending day, you will simply get whipsawed and lose more money. Five, you may want to double on the reversal, for this is often a powerful trade and the losses will be recouped quickly. The nice thing about the reverse-and-double strategy is that you only need one-half the move to recoup 100 percent of the losses on the previous trade. Six, you must not reverse on every trade.

The rule concerning market orders is perhaps the most important to remember. When you buy or sell at the market you can almost always find someone to take the other side. What do you care if you pay up to get a position if it is about to run in your direction? There are times when you do have the luxury to pick and choose your price carefully, but not when you have just exited a losing position and want to reverse. I know the prices on the screen may seem inviting, but chances are the rally or break is already underway and there simply isn't any trading taking place at that price. As in football, where a winning touchdown can often be accomplished in the final 15 seconds, creating a new winner in the game, a few precious moments can make all the difference in the futures market.

Knowing that you should reverse and doing it are different. That's why you want to think about this strategy before the reversal situation presents itself. After all, you have just taken a loss when you reverse, and you may indeed be setting yourself up for more losses. This is an emotional situation. But if you are to trade like a professional, you must be able to quickly extricate yourself from a difficult situation and try to take corrective action. The tendency is to want to "watch" the market a bit after taking a loss. This is a mistake. The reason is simple. If the market soars out of sight when you are waiting to get up the courage to take the trade, you have missed the move! Chances are, it is not coming back — nor, for that matter, would you want it to. If the market again retreated, the move probably wouldn't be any good. Once mastered, of course, this strategy, in which you must risk

throwing good money after bad, will stand you in good stead.

Successful trading involves overcoming your own personal shortcomings — not beating the market. Winning traders know what they must do to win. Having control over their emotions and taking intelligent risks is the key to winning.

Since the reversal trade is, in part, an attempt to undo the damage created by the first losing entry, you must monitor the trade carefully. You are striving to accomplish two goals at once. One, you are trying to win back the money you just lost. Two, you are trying to capture the short-term trend and earn a profit. As with any trade, you must be waiting to grab the profit that the market gives — not the one you want or feel entitled to.

A word of caution: good things tend to be short-lived in the futures market. When you reverse — especially when you double— and the market runs your way, be wary of the initial euphoria you will experience. This is the time to be cautious, not reckless. Nail down the profit and congratulate yourself for the presence of mind to trade yourself out of a difficult situation. Relatively few futures traders have the courage to implement this strategy.

Readers who have purchased this book in hopes of finding ironclad rules will, by now, know there are exceptions to every rule, and the stop-and-reverse strategy should be advised only with this cautionary note. On average, about one trading day a month will experience the kind of whipsawing price action that people in the trade call a "search-and-destroy" day. This price action is characterized by violent up-and-down moves in which the newly-established intra-day

highs and lows are continually violated. You need to be wary on such days. Reversing will almost certainly prove disastrous. Just as you are convinced the market is about to surge higher, you'll find the market reversing. At the bottoms, when the trend down seems likely to be down, you sell short and the market again rises. To protect yourself from such price action, you must stop trading once the reversal strategy fails on the third or fourth try. Otherwise, what started out as a modest, small loss will almost certainly grow to a large loss — one which you will be regretting for a long time to come.

I approach each reversal situation in the same fashion. On the basis of the prevailing price action, am I likely to get a good pop or break? Or, on the other hand, is the range too small, the participation too light, the trend uncertain? Are today's circumstances similar to other days when the market ran? And always, I've got one eye on the clock. If we are approaching the noon hour, perhaps the market is about to go dead or drift sideways. If the market has only been open for 20 minutes, however, perhaps it will run. If we are in the final hour, with even 30 minutes to run, I know there is still plenty of time to get out of trouble by reversing. This is a realistic and satisfying way to trade. Trading is an art, an incredible intellectual challenge, and the better you become at making these judgments, the better your trading will be.

There are times when the energy in the market is so intense that the impending move is almost palpable. Such a day was October 25, 1994 when I'd sold the gap down opening break of more than 200 points in anticipation of the bottom falling out. The market had traded as high as 463.50 the

previous day, prior to selling off into the 462.25 area at the close. The open at 460.00 suggested something was terribly wrong with the market. I sold immediately, thinking a much larger break was imminent and I didn't want to miss being aboard this significant move. Ten minutes later I realized I'd made a mistake. Instead of falling out of bed as it should have, the market was 50 points higher at the high of the day and holding. I paid up immediately. Then I began buying the highs as the market soared. Five minutes later I liquidated the reversal trade at the previous day's close, almost 300 points off the low of the day. Quick thinking had salvaged a certain loser.

Although the market later trended still higher, the previous day's close had been the logical place to sell. For one, this was the significant "value area" where it had traded for some 30 minutes prior to yesterday's close. There would almost certainly be profit-taking there, and there was. The market went into a counter-trend as it established an equilibrium area on the first leg up. Prior to the completion of the 11 o'clock morning trend, the market traveled approximately 400 points in two distinct legs. I got out on the first leg, happy to have extricated myself from a potentially disastrous trade. As noon approached, the market exhausted, and it traded down into the value area where it churned sideways into the afternoon.

I don't need to tell you there is simply no time to fool around with limit orders in such a situation. The point is, you have to act without hesitation. There was absolutely no future in holding that initial short position. Three days later, the

market was trading in the 475.00 area. I'd sold the low of a major upmove — and, with the wits to reverse quickly, still made money! What a satisfying trade!

The key to knowing when to reverse was the price action. When you sell a sharp break on the open, the market should plummet immediately. That, after all, is why I took the short position in the first place. I didn't want to miss an overwhelming bearish day. But it was nothing more than a bear trap and I had to trade out of it.

This reversal trade also illustrates the notion of the "paradoxical event." That's when every last long gets absolutely murdered just prior to a surge in prices. Believe me, anyone who was long that morning, watching the market plummet on the open, was likely to have seen their overnight stop-loss sell order hit or had the phone in their hand, ready to sell. This was a clear-cut case of the paradoxical event. These seemingly nonsensical events are what creates so many losers among the army of futures traders. What seems correct actually isn't. How often have you heard the comment, "I was right on the market, but I lost money"? Given market action similar to this, it is indeed quite understandable. These paradoxical patterns are especially evident at key market tops and bottoms. Isn't this what Taylor had been talking about right along?

This illustrates why it is possible to make money in the futures market without knowing what the market will do. Too often, the emphasis is on "hot tips" and the like, when the actual answer is simply knowing how to trade.

PUSHING THE CYCLE AHEAD

Since anticipating the correct daily pattern is invaluable in selecting trades, it helps to know what to do when the market appears to be out of "synch." As night follows day, we know that markets rise and fall. So when you are having trouble finding the cycle, you need to rephase. Taylor suggested going back ten days and taking the lowest low and then counting ahead in a 3-day pattern — Buy (on the lowest low), Sell, Short Sale, and so on. Another strategy is to simply look at yesterday's pattern. Let's say you anticipated lower prices. Instead the market rallies and closes on the highs. No problem. Push the cycle ahead a day and call yesterday the sell day. Now you have the short sell day scheduled for today with, hopefully, the high made first. Knowing how to find the correct pattern is invaluable in trying to figure out the correct approach to take in trading. Once you have the patterns, there are numerous techniques you can use to plug in specific numbers to trade.

Taylor's market "engineering" theory, which goes to the heart of the 3-day cycle, was originally created for the grain markets of the nineteen-fifties, but since that time I have observed the presence of the cycle in the stock indexes and interest rate markets, the metals markets, livestock and currency markets. It has become clear to me that these cycles exist, even if they are only produced by stop-running instead of some diabolical insider conspiracy.

The up-is-down paradoxical notion of markets is such a compelling notion that I am surprised that not more traders

have embraced the idea. The crowd is clearly wrong at the major turns. I am reminded of a trader I used to know who would hit all the bids in sight, delighting the buyers who thought they'd gotten a real bargain by purchasing the "edge," or difference between the bid and ask. This trader would gladly give up the edge when he felt he'd had the direction correct. Sure enough, there was nothing but panic on the buyers' faces once the market dived and they were caught trying to sell contracts in a breaking market. This also illustrates the relationship of buyer to seller. There is indeed a buyer for every seller in the market. But this doesn't exist in a one-to-one fashion. Instead, there may be one knowledgeable seller and one-hundred individual buyers. It is the small panicked traders that typically lead in the breaks. Given these numbers, it is not hard to see how ten percent of the participants earn 90 percent of the money.

According to Taylor's theory, it was the same knowledgeable few who stood to profit on what he called the "engineered" moves. More accurately, I suspect the "engineering" need only have been minimal since so many traders tend to be their own worst enemies. "I bought the first break, I bought the second break," goes the popular refrain. "I was the third break." There is plenty of evidence of high- and low-balling in the market. It is often just a question of getting the price to where the stops are. Then the public traders, whose stops will be hit, will panic and you have a blood bath of sorts, until reason once again is restored in the market.

The ebb-and-flow of this cyclical pattern indeed seems inevitable — and then it repeats endlessly. The question is,

how good are you at capitalizing on the opportunities that arise from these cycles?

LSS — AN INTERPRETATION OF TAYLOR'S 3-DAY CYCLE IDEA

The new LSS software, which has recently been extensively revised from the original 1985 version, offers a sophisticated interpretation of Taylor's three-day cycle idea, taking into account the existence of the cycle into a four- and even five-day pattern. In researching cycles over the past ten years, when, significantly, bull markets have been predominant, we have found that genuine breakouts require a sustained commitment, lasting over a period of two, three, or four days. Only then, does it seem, that the cycle runs its course. We know these cycles don't occur frequently. But in terms of their contribution to the bottom line, they are important, even for the day trader. And, in discussing this cycle extension phenomenon, we need to remain aware of the paradox involved. On a modest rise in prices, a market might call out to be faded. But a moon shot on the open means you have to buy. Whereas the modest rally will fall due to gravity, the moon shot exceeds the gravitational pull.

Once you become comfortable with these apparent contradictions (the paradox), you will cease trying to force last week's barn-burner market into today's much more lackadaisical trading affair. It goes back to the concept of exhaustion. When the move is over, it is over. If you didn't participate in

yesterday's big move, you might as well forget it. Because until the time is right, you aren't going to see that kind of price action in the next several days. Witness the S&P 500 market which has steadily grown more volatile over the years. Yes, you can make the argument that at these levels, the same percentage move as five years ago generates a wider range. But why do we now have numerous 700- and 800-point days whereas five years ago, these were a rarity? Even still, it is commonplace to have 800-point days followed by 250- or 300-point days. Perhaps the correct explanation is that the market often gets exhausted.

The problem for the connoisseur of market cycles is that the numbers-crunching gets confusing. If, for example, you are basing your analysis on a series of relatively low-range days, you aren't going to be prepared for the big day — the very day, in fact, when you truly need to ride the trend and milk it for all its worth. Conversely, the occasional aberration in prices will likewise skew the numbers. The solution is to generate a series of numbers for a variety of circumstances. This is the precise reason that the new LSS software generates no less than five potential trading signals on each of nine futures per day. You will never get all five, because they tend to be mutually exclusive. But you may indeed get two as the success of the trade becomes more evident, suggesting a greater commitment.

The single greatest help in understanding a change in the cycle pattern is patience.

Markets tend to revert to form. So if you are patient, you can typically spot the new emerging cycle pattern and plan

your trading strategy accordingly.

CONFIRMING INDICATORS

A market does not exist in a vacuum. There are always complementary indicators, markets, and news events that influence how a single futures market behaves. Indeed, there are often so many of these, the problem becomes how best to sort out the abundance of information rather than a dearth of news. The key is knowing how to interpret the many facets that go into the supply and demand equation.

Every market technician will tell you he has favorite confirming indicators. More telling perhaps is that these indicators will change from time to time. And I'm certain you know the reason. They stop working. So analyst A will be a proponent of on-balance-volume and analyst B will be a proponent of, say, divergence techniques and, down the road, they will switch pet indicators. Certain analysts have even made careers of embracing specific indicators. I must confess a fondness for Taylor's work and time and price studies. There were times when I used to carry around huge multi-colored Gann charts. But like most believers, I grew wary of that strategy one day, and moved on to the cycle pattern approach. One of my favorite quotes is about intolerance and talking behind people's backs. But it applies to market analysts as well. It goes like this:

"There is so much good in the worst of us, and so much bad in the best of us, that it hardly becomes any of us to talk

about the rest of us."

I don't recall who originally said this, but it reflects my sentiments concerning market analysts and their theories. Frankly, I don't care if you rely on tea leaves, if it works. There is so much emphasis placed on secrecy and not letting anyone know some formula or technique, that I doubt if it makes any difference. The funny thing is that the degree of insistence on secrecy is often in direct proportion to how inept the technique or strategy actually is. Having said this, I certainly wouldn't want someone publishing my LSS numbers on the Internet. People who purchase proprietary software should know that the information is privileged. But you simply cannot crunch numbers and come up with the correct answer every time.

Because successful futures trading requires such an incredible blend of brains, talent, courage and money, I wasn't surprised when a seven-figure-a-year S&P pit trader explained to me once: "I don't mind sharing my trading secrets. I don't think anyone can duplicate what I do anyway."

The place to start looking for the confirmation of a pattern is futures price action. Of all the indicators available to you, this is the most valuable. For many, the fundamentals and trying to glean price direction from news reports determines their slant on the market. And they have a point. Long-term, the market will conform to the dictates of supply and demand. But when it comes to trading the market short-term, the technical — and really, the psychological — factors are much more influential. For this reason, you have to learn to look at price as the sum total of opinion on the market at one

moment in time.

There are two approaches to using price to determine future market direction. One, you can simply guess and hope that you are correct. Two, you can use price to tell you which way the market is headed.

The first approach is fraught with difficulty. Your guess is often mistaken. The second, while not always easy, can be misleading unless you know what to look for.

BE PATIENT AND SELECTIVE

A word of caution: to be consistently successful in finding sound patterns, you must be selective. This means you will not find a readily identifiable pattern every day. Moreover, you must be patient. On average, if you can find three good patterns per week, you will be well rewarded.

Why this warning? Trading patterns are notoriously deceptive. While some pattern will emerge everyday, you are doing yourself a disservice to think you can identify it quickly enough in order to capitalize on the situation.

The day's pattern is often telegraphed by initial price action. Take the case of a sharp selloff when the Dow ends the day off 50 or 60 points. What is likely to occur on the following day? Typically, you are likely to have a continuation of the selloff in the initial first hour of trading. This is understandable, since traders (especially unsophisticated stock traders) have had an opportunity to digest the news. They don't want to be aboard a sinking ship. So they jump overboard.

Once their reckless selling at the bottom culminates, however, the market is free to rise as the inevitable buy day pattern kicks in. This is precisely why you want to be thinking with your head and not panicking with your emotions when you trade. Although you will occasionally get back-to-back declining markets, the probabilities favor the Buy-Sell-Short Sell Day pattern. The market is taken lower to create the buying opportunities for the smart money. So what else is new?

THE ART OF INTERPRETING THE INDICATORS

Futures prices, obviously, are the first thing the analyst wants to observe in trying to predict patterns. But there are a host of primary and secondary indicators that can help you select the proper pattern. Computers have permitted us to study charts of selected indicators side-by-side for hints of divergence. You'd be surprised how often a divergence will serve as a key leading indicator. On my TradeStation, I track the following four charts: S&P cash prices, Dow, TICK values and premium. I keep them on the same page in order to easily spot a divergence. Moreover, I track them on one-minute line charts as opposed to bar charts. After all, I'm not interested in their overall values as much as the velocity and direction of their values. The interesting thing is that no single indicator serves best as the leading indicator. One day, the cash may be the key; on another day, the TICK values may provide the clue. The market is like a giant jigsaw puzzle. And successfully putting all these pieces together is the key

to finding the emerging patterns.

Unless you understand what should occur on any given day, you'll have no idea how to spot a legitimate divergence that suggests a temporary rise or decline is about to end. These divergences, which at times are almost impossible to detect, are what I call the "hidden clues" of the market. Their appearance in the market suggests a lot of people are about to be disappointed, although most will never know this until it is far too late to do anything about it but take their losses. It is why only the minority win in the market and why trading can be so overwhelmingly frustrating to the uninformed or those who are simply too new to understand the challenges involved.

The traditional pattern is for all four — TICK, cash, DOW and Premium — to track together with price. So if the market is declining, all four will be falling. The divergences, of course, tend to occur at the turns — bottoms or tops — where one or more indicators gets out of synch with the others. As a rule, futures lead price moves and the premium frequently reflects this. You will, for instance, see the premium rising as futures traders bid up prices in anticipation of the cash price subsequently rising. On most occasions, the cash price cooperates and, although lagging behind, goes in the direction of the futures. There is no secret why the premium is frequently the key, at least in the short-term, to the direction of prices. Remember, the cash price index is calculated only once per minute. The floor traders, who have access to the NYSE tape, can often see key stocks moving during the 60-second interval between calculations and they use this as a tool to buy or sell. The reasoning is, of course, "well if IBM just ticked up,

chances are the next cash index price will be higher and I can sell these contracts at a profit." That's the theory.

In practice, however, especially at the turns, you get the unbridled emotionalism of the trading pit taking the premium out-of-line and the move gets overdone. This is when an astute observer of the market can sell a high premium or purchase a discount and make some nice money.

Having said this, the reverse can also be true. A market goes to a high premium, let's say, and the futures get ahead of the cash market. Depending on the time of day and kind of market you are trading, you may want to buy at these inflated levels on the theory that some significant news is in the market. On these big news days, it doesn't matter where you get in as long as you select the right side. But this tends to be the exception.

The real art of trading begins when you can look at two of more of these indicators and make accurate interpretations. Let's isolate them at first and see if we can make some headway. Let's say the S&P market gaps 100- to 200-points higher on the open with a corresponding 200-point rise in the premium. But in the opening moment, the premium begins to plummet. What is this decline in the premium telling you? Simply that the floor traders and other participants in the market are having no part of this rally. They are aggressively selling into this rally, causing the premium to fall. The cash price may indeed even be rising at this point. What the premium reflects, of course, is the difference between the futures and the cash price. So it could be futures down, cash up; or futures down, cash stationary; or futures down, cash down

less. The premium is signalling the break.

Likewise, a sharp drop in the TICK values (Advancing NYSE issues minus declining NYSE issues) can occur prior to a move in either the futures or the cash. This makes it a leading indicator. The more you study these chart formations, the more convincing evidence you will accumulate.

THREE

The Morning Trade

I like to compartmentalize my trading into two distinct parts — morning and afternoon. Because these two complement one another, the morning trade frequently creates the first leg which, given the symmetry of price and time, culminates in the second leg in the afternoon. So you might have half the rally in the morning and the other half in the afternoon. Or the morning's rally is offset by a comparable afternoon decline. When carefully analyzed, however, the morning and afternoon sessions can be remarkably different in character. This is why I treat them as two distinct trading sessions, although, I must confess, there are times when the trade taken on the opening bell is only liquidated at the closing bell.

As computers have become more powerful and useful in analyzing market data, analysts have begun to rely on them more and more for spotting trends and identifying useful market tools. In using computers to help me trade in recent years, I've found that they've helped quantify the educated guess or hunch. Sometimes you know something on an in-

tuitive level without sufficient evidence to make it a rule. Identifying the morning trade as a viable entity is one conclusion which the computer studies have helped me confirm.

By breaking down the trading day into two components, the characteristics of each trade tend to become more clear. There may be, as we've discussed, an up-sideways-up pattern in the morning trade. Then, hours later, an identical pattern may appear in the afternoon trade. This is the market symmetry at work.

Any genuine inquiry into the nature of the markets must, by definition, consist of a host of "what if" questions. What if I "faded" every opening gap? What if I gave each trade, say, ten minutes to prove profitable or I exited the position? What if I reversed on losing positions? What if I picked critical periods or times during the trading day to enter or exit the market —what would be the overall impact? There are endless questions and, I'm pleased to say, some very interesting responses. So many, in fact, that several years ago I began to think, "Why didn't I think of this ten years ago?" Ah, the pleasures of experience. There is so much to learn. It just seems that the price of experience is so extremely costly in the futures market.

It certainly makes sense why so many who matriculate in this particular school fail to graduate. The tuition is too high! Not long ago, I was having a conversation with a fellow trader who was bemoaning the fact that so many new and inexperienced individuals were entering the market. Hold on a second, I wanted to say, who do you think provides the profits? The reason the game has become so difficult to beat in recent

years is precisely because the level of sophistication has risen. A lot of people these days have access to computers. Naturally, the professionals have had to work harder to keep up with the technology.

THE OPEN

The place to begin any inquiry of how to trade on any given day is the open. For the day trader, the open is the time of virtually limitless possibilities. The day is new and fresh and yesterday is just a memory. It is a time when you have not as yet committed a single mistake. And there are thousands of fresh new dollars just a few trades away.

From a strategic point of view, it is a time of intense activity. How you play the open, or, at the very least, what conclusions you draw from the initial opening activity will likely determine the success of your trading day. The open is a time of extreme liquidity with an abundance of buyers and sellers all jostling for the competitive edge. It is a time when prices occasionally get taken "out of line," offering some of the best trading opportunities of the day. Significantly, it is frequently a time when the high or low is registered.

While the open can indeed prove enlightening to those who know what to look for, you must do your homework in advance if you are going to turn the morning spurt in prices to your advantage. It helps to be armed with a shopping list of support and resistance levels, prior highs and lows, not to mention a sound knowledge of your market. This is all sec-

ond-nature to seasoned traders. They live and breathe these numbers. They know the interim high and low of the last move that topped out last Monday afternoon, say. If they are floor traders, they know where Merrill Lynch came in selling 500 cars yesterday — and how it was taken in the market. They know whether the Fed chairman is scheduled to speak this afternoon — and the Street's opinion of the likely news. And, of course, like most good traders, they know yesterday's highs and lows, including the intra-day numbers and how the market behaved just prior to the close. All this information must be processed and understood prior to the open. This makes the actual decision-making a virtual afterthought once the opening bell rings.

Timing, we all know, is critical in the futures market, but the speed with which you act becomes doubly important at the open. Because of the inherent uncertainty and volatility that is characteristic of the open, the speed with which you act is so vital that, on occasion, you may want to enter the market on a "market on open" order. I know you can make the case that, under certain circumstances, it is best to let the market calm down before placing an order. But there are times when waiting makes no sense. In markets that exhibit strong trends, buying or selling the open is often the best strategy. I have mentioned the summer of 1987 when a trending market returned excellent profits on the simple strategy of buying the open, buying the first break, and buying double the quantity on any downward penetration of the first break. With few exceptions, this simple strategy generates consistent profits in a trending market. Significantly, the second and third en-

try levels were not always hit. That meant a failure to buy on the open would have meant none or lower profits on the day, as the market frequently soared out of sight.

While the open is normally one of the high-volume points of the day (the close is another significant high-volume area), you want to watch tick volume at this critical time. In particular, you want to watch whether the high volume occurs on rallies or declines. A market that rallies on high volume and pulls back on low volume is signifying a dynamically different trading situation than a market that declines on high volume and struggles to rally on low volume. The key is the direction of prices on high volume. The rule is, the market wants to go in the direction of the high-volume move. This is doubly important on the open, because this is the time when the day's first trend is scheduled to appear. Accordingly, look for tick volume to soar when the price moves in one direction or another. That's the path of least resistance.

The other point where you will encounter high volume is when a reversal occurs. If the market opens, breaks lower, and quickly snaps back up off the bottom, chances are the move will be accompanied by high volume. This is the point where you get a lot of stops, a lot of traders are changing their minds, and a lot of new money is coming into the market, which is accurately reflected by a significant rise in the tick volume.

If the timing is correct, and you get some confirmation of the validity of a trade shortly after the open, you are ready to take the first trade. Now, you don't want to take this step lightly. Every trade is a commitment not only of money, but

of your energy, and the results can have a profoundly positive or negative impact on your psychological ability to go forward in your trading career. I'm thinking of traders who made serious mistakes and who compounded their problems by refusing to acknowledge these mistakes. So you need to think through your strategy before you haphazardly take on a position.

Given the timing, chances are this first trade will prove profitable or unprofitable almost immediately. In short, you will have a decision. As a general rule, the winners will take care of themselves, but the losers require immediate attention. An immediate winner suggests the trade is correct — even if subsequent price action eats into your profits. If you get profit-taking after an early pop, this can be seen as an opportunity to add to a fundamentally sound position. The key to success rests with the amount of time that the adversity persists. If the market comes back quickly — say, in 15 to 25 minutes — you probably have a winner. If, on the other hand, the market turns negative on your position — and stays negative — chances are you are on the wrong side. I try to keep myself honest in this situation by carefully monitoring key indicators — futures price, cash price, TICK, volume, Dow, etc. — in specific time intervals and comparing their respective directions. Thus, if I am long and a host of negatives have entered the market, I try to decide whether this is a temporary setback on an overall higher day or whether the trend is changing. I want higher readings, designated by an UP, as opposed to a DOWN as a lower reading would suggest. Then I assign a fixed amount of time that I'm willing to

wait for improvement. This might be five or ten minutes or some interval in between. But I am rarely willing to wait more than twenty minutes, because this suggests my initial position was way off in terms of timing. Remember, we are talking about shortly after the open here, not the noon time when the market may churn sideways for an hour or more. I want confirmation when I'm adding to a position — and I want it soon.

HOW TO MONITOR THE MORNING TRADE

The key to success in monitoring the morning trade is tracking price and time along with the key and secondary indicators. The reason that speed is important, as we have suggested above, both in entering and exiting a position, is because the probabilities favor one end of the range being established in this critical time period.

Your choice of indicators to monitor, of course, will be dictated by your market. Nevertheless, some, such as futures prices, will be a critical factor for everyone. So that's the place to begin your inquiry. How is the futures price behaving, both before and after you enter your position? While market adversity, especially in the early going, is commonplace, there is a limit to precisely how much you are willing to sustain. It is difficult to assess a fixed time limit on an initial entry position. There will be times when you will recognize a mistake in the very first minute; at other times, you may need to hold a position 15 or 20 minutes. One trick I use to determine

whether I want to hold a trade is by asking myself, "Would I really want to be the guy on the other side of this trade?" Chances are, he's struggling as well, since the jury is still out on which of us is going to prevail. I know that this can sometimes feel like you're standing in a cold shower tearing up hundred-dollar bills, but there is no easy solution to the age-old question, "Am I on the right side?"

As I've mentioned above, I compulsively take notes on the market, even though I have a comprehensive charting program on my TradeStation screen. The bar charts aren't enough for me, I want numbers and times so that I can go back and analyze my trading decisions. I find it is harder to fool yourself if you are writing down these specific numbers at specific intervals. For instance, if notes tell me that the cash price was 782.25 at 9:45 AM. and 782.50 at 10 o'clock and 783.02 fifteen minutes later, is there any chance I can continue to hold a short position into this rally? Chances are, I exited a losing position long ago. Actually, I find five-minute intervals far more helpful.

When working with the cash prices, therefore, I'll write down the price and time of day. Then, at five-minute intervals, I will register another price until I have a series of prices. With each new entry, I can make a designation as up or down. Two or more consecutive negative readings on the cash price should be a sign, taken with other indicators, that perhaps you are on the wrong side of the trade.

This monitoring approach becomes particularly helpful when it comes to liquidating the trade. That's because many short-term morning trends last just 25 to 40 minutes, and of-

ten times less. This is the period of time that will typically pass before profit-taking enters the market and you have a pull back. To capture these short-term moves, you may very well want to monitor the change in values at an even shorter interval — say, every three or four minutes.

The short-term movements of the premium also become critical as the futures and cash prices begin to gyrate as the market approaches significant intra-day highs and lows. Understandably, the premium can provide an important clue as to whether the market has run its course. Again, my suggestion is to track the premium price by writing it down. Unfortunately, there is no simple rule for interpreting premium prices. But with experience, you may begin to notice certain patterns. A high premium may be interpreted, for example, as extremely bullish since the futures traders are now willing to pay higher prices. On the other hand, a high premium may suggest that the futures got "out-of-line" with the cash and prices will soon retreat. Typically, the premium will move first, meaning the futures are leading the market. Stationary cash and higher futures prices will cause the premium to rise; stationary cash, lower futures, will result in a decline. And, of course, both may indeed move at different rates — significantly, in the same, or, occasionally, different directions. These price movements will all have a bearing on the premium.

The rule for spotting a trend is when the premium moves and continues in one direction. This can be in either direction.

Another indicator to track is the TICK. This is a number which is derived by taking the number of advancing issues

on the New York Stock Exchange and subtracting the number of declining issues. A variation of the TICK is the TICKI. This latter indicator is the number of advancing minus declining issues in the 30 stocks comprising the Dow Jones Industrial Averages. When you take these different indicators and compare them, you occasionally can spot divergences between the indicators, which suggest the market is about to reverse or at least some sort of profit-taking will interrupt the trend temporarily.

One strategy is to draw up a spread sheet list of indicators and watch for a divergence to occur. For example, a sample form might occur as shown below:

Position: Buy

Time	Futures	Cash	Premium	Tick	Dow
9:35	UP	UP	UP	UP	UP
9:50	UP	UP	UP	UP	UP
10:05	UP	DOWN	UP	DOWN	DOWN
10:20	DOWN	DOWN	DOWN	DOWN	DOWN

It isn't hard to spot the divergence here. One explanation for the higher premium on a decline in the cash is some sort of panic short-covering which was not justified given the subsequent slippage in the indicators. You can also use these designations in concert with the actual numbers which can then be quantified in order to further refine the analysis.

STOPS

All positions need to be protected. You must never allow a small loss to grow into a large one. So if you don't have the discipline to exit a losing trade, go ahead and place a stop. As a general stop-placing rule, however, the dilemma is this: stops placed too closely will invariably be hit, and stops placed too far away result in losses which are too large. We have run studies on where best to place the stop. The most accurate answer rests with the volatility of the market — more volatile markets require larger stops. But in the S&P 500 market, we often start with a stop in the morning trade which is 140 points from the entry and rapidly move the stop closer as time passes and the market moves favorably. Significantly, afternoon entries can often be protected with stops which are closer, since the trend is often more certain at that time.

There is no easy solution to the stop-placing problem. However, you must devise a system for dealing with adversity, whether it occurs right after you enter the trade or after you have a winning position. The rule is to move the stops in your favor once you have some profits. But here, again, you are on the horns of a dilemma. When exiting on a stop-loss order, by definition you are giving up something when you get out. Why not try to track the trade and exit before the adversity is well known? This means exiting long positions on strength and short positions on weakness. The drawback with this method is that you are occasionally viewing a temporary setback as the signal to get out. One means of dealing with this is to take some of your profits when the market first

shows signs of slowing down in the trend and allowing others to continue to work for you. Looked at minutes later, with 20-20 hindsight, you will find that this meant you exited prematurely, or, perhaps, you should have exited the entire position at the first sign of adversity. But the point is you didn't know this at the time. After all, you are attempting to make money — not pick the high or low of the day.

One way to deal with the stop-placement dilemma is to use what I call "Action Points." This is a price where I suspect the position might be in trouble. Having hit the AP, I must plan a retreat from this position. But rather than exiting immediately, I'd prefer to wait until I can get a more favorable price — perhaps a temporary bounce off a low if I'm long and need to sell. The risk, of course, is that this bounce will never occur, and the market will plummet before you have an opportunity to liquidate. Obviously, the placement of the AP, and the subsequent exit point, is a judgment call. This takes experience. By demonstrating patience, however, you can often await a favorable move in the market and exit the position.

A word of warning: once you decide to get out, you must do so. Don't change your mind in hopes that the market will come back. The market will only give you so many chances before moving against you.

When there is doubt about the use of a stop order, you need to monitor the market closely to see whether there is some opportunity that this position will turn into a viable trade. We have mentioned some of the key indicators you need to watch. We'll try now to put them together with some other

indicators to see whether we can create a check list of circumstances that most favor the trade.

HOW TO EXIT THE MORNING TRADE

If there is no doubt that your trade is a winner, the ideal way to exit is to sell into strength or buy into weakness. I call this technique "reaching for the exit," since you are placing a limit order above the market when selling or below the market when buying. It is a satisfying way to trade because almost all legitimate tops and bottoms are made quickly. If your order is sitting there near the top or bottom, so much the better. Chances are, there will soon be a counter-trend and the hapless crowd will trip over themselves racing for the exits, butchering themselves in the process.

To gain the confidence to know where to exit the market, you must become familiar with measuring the market, sizing up the legs, anticipating the time limitations of a given rally or decline. This is a challenging enterprise, but certainly not without its rewards. The point to remember is: markets trade in a zig-zag pattern. Trends will meet with profit-taking. The key is knowing when the move is overdone — and, significantly, when a genuine trend exists that should keep you long or short until the close.

First and foremost, the big trend days are when you can make some truly significant money. Do <u>not</u> cut your profits short on such days by taking profits prematurely. This is a big mistake. For example, let's say you are long and the

market suddenly screams 400 points in your direction. Do you take profits — or do you stay with the position? This is not as easy a decision as you might think. The easy solution is to take the money and run — and, indeed, this is often the sensible approach. But you must remember the time and price rule. With 400 points in the morning trade in the first hour, perhaps the market is good for a comparable move later in the afternoon? Perhaps it is good for even more? Perhaps there won't be a pullback?

Perhaps the market is destined to close 1,200 higher on the day? If it is, you are far better off staying until the close. But how do you know?

The fact is, you'll never know for sure. But you do need to think about the probabilities.

THE TURNAROUND NUMBER

The notion of the so-called "turnaround" number is important in entering the morning trade. So named because the market must indeed "turnaround" prior to an entry being signalled, the turnaround number is the price at which the market must trade prior to changing direction and trading at yet another price. Put simply, the turnaround number works as a pivot number at which the market changes direction. When buying, the turnaround number is a low point at which the market must trade prior to moving higher. When selling, the opposite is true: the market must first trade at a higher price prior to retreating lower. Both the moves higher and lower

and the magnitude of the retracement are significant in making the turnaround numbers work.

Borrowing from Taylor, we have discussed the paradoxical likelihood of a rising market first going lower. The reverse, of course, is true in declining markets. To fully comprehend this phenomenon, you must first understand what is really going on in the market. Why, for instance, would a rising market first fall? The reason is very simple. The market consists of the fears and desires of an infinite number of individuals all operating in their perceived best interests. Since the perceived "best interest" of one trader might be to take a loss (usually via a stop) while another less risk-adverse trader might be willing to buy at the same price, you have a transfer of money from one group of traders to another at key support and resistance zones. Having accomplished this one function of the marketplace, prices are then free to move in the opposite direction. The entry price is then established as the market moves a given magnitude in the opposite direction away from the turnaround number. Put simply, there are two key numbers: the turnaround number and the entry number. Calculating these precise numbers is a real challenge, since the numbers will vary from one futures contract to another. My LSS software, however, attempts this calculation. Yet coming up with the ideal turnaround number is never easy.

In order to fully appreciate the phenomenon that permits the turnaround number to generate a winning trade, you need to have an understanding of how far the market trades in one direction prior to reversing — and even then, you must be able to separate random moves from genuine trends. Ask your-

self: How far should the market trade in one direction prior to a bounce in the opposite direction? Indeed, if the so-called "bounce" is inevitable, why not simply buy or sell at the turnaround number? Good question. But the fact is, the bounce isn't inevitable at all. A market might reach a turnaround number and continue in the same direction. Hence, the need for the actual turnaround in prices to legitimize the move. But then you must ask: Assuming we have a turnaround, how far must the market trade in order to signify a legitimate entry? Again, the answer has to consider the futures involved, the current volatility of the market, and, of course, time and price. We know that significant intra-day highs and lows are made quickly. If a market goes to a turnaround number and simply dies, it is one thing. If, on the other hand, it hits the turnaround number and snaps back with authority, you probably have a winner on your hands. This "price rejection" is an important clue. Because any time a market moves away from a given price quickly, it suggests there is a lot of enthusiasm for buying or selling at that price. Someone is willing to pay up to enter the market at that point. This, after all, is how support and resistance zones are created.

Another way to talk about this same phenomenon is to explain that the market simply gets "out of line" at certain price levels. This means it becomes irresistible to buyers or sellers at different levels. It also suggests that the "bounce" then becomes inevitable.

A question I often get concerning LSS is: "Does the system try to predict the prices for the next day?" The answer is a resounding "NO!" We are not trying to predict or forecast

anything. All we are saying is, "If the market trades at a certain level tomorrow, there is a high probability that it will trade at yet another level." We are engaged in discussing probabilities — not forecasting markets. Knowing the probabilities, we can then capitalize on this knowledge with confidence. If you told me that nine times out of ten prices trade at level A and then subsequently trade at level B, they will go to level C, I'm not going to fade the trade. No way. After all, I could care less where it trades, as long as I have the right side of the market when it goes. The problem is, allowing the trade to properly develop often requires a combination of extreme patience with a willingness to act abruptly. You have to wait in the woods but then seize the moment when the opportunity avails itself.

You would be surprised how many traders prefer the "action" of trading to making money. "How often does the system trade?" is another question I often get. You may wait three or four days for a trade, but then you may get five or six entries in a couple of trading sessions. It depends on market behavior.

I am convinced that this is the only sensible way to beat the market. Taking the probabilities and honing them to a point where they are resoundingly on your side. Otherwise, you might as well be shooting dice. Sure, you could get lucky in the market. Rare is the futures trader who hasn't experienced such runs of luck. But if you want to treat it as a profitable business, you must be willing to rely on the probabilities.

How does the entry number work? Remember, in using

the turnaround number to buy, the market must first decline and then retrace back up. So you are purchasing strength. When selling, the reverse is true. The market has rallied to the turnaround number and now has retraced in a downward direction — so you are selling weakness. This is the strongest way to trade: in the direction of the trend. Having registered, say, a low and come off the low, the market is poised to go higher. And here the paradoxical nature of the market is evident. Namely, as the market trades higher, it actually becomes stronger. More and more buyers enter the market and prices can only rise. The reverse, of course, is true in a market that declines. Given this phenomenon, you can see why we wait for a rally to buy. The market has not only turned direction off the lows (price rejection), but it has gotten to a level from which is becomes highly unlikely the low price will be seen yet again in this trading session. This is an ideal trading opportunity. And when does it often occur? In the morning, shortly after the open. Once the stop-running has occurred and the market has changed from weak hands into strong hands.

FIBONACCI NUMBERS

There are many ways to use Fibonacci numbers to trade futures. Rare is the futures trader who doesn't have his own pet Fibonacci theory. But the one I am discussing here I discovered quite by accident one day while examining one-minute bars on my TradeStation. First, for those who may be

unfamiliar with Fibonacci's work, a brief introduction. Leonardo Fibonacci was a thirteenth-century Italian mathematician who discovered the series in which each succeeding number is the sum of the two numbers immediately proceeding: 1-1-2-3-5-8-13-21-34, and so on. Because I am an aggressive in-and-out trader, I look primarily at five- and one-minute trading bars.

Actually, I discovered this use of Fibonacci numbers one day quite by accident. It was after market hours and I was busy studying the day's pattern. I was aware, of course, of the likelihood of the day's high or low occurring in the early minutes of the day. I understood this both on an intuitive and empirical level; we had the research to back our assertions. As one who is always looking to "fine-tune" his trading, however, I wanted another tool to help me pinpoint the exact moment when a trade would be most desirable (i.e. least subject to risk). This, of course, is impossible, but why not strive for improvement? My thinking went like this: what if, I reasoned, I counted one-minute bars off the open? Would a pattern appear in which I could have confidence? Moreover, what if I counted ahead in one-minute bars using Fibonacci numbers? Farfetched? Don't take my word on this, try it yourself and see what you find. Remarkably, I discovered that the market often turned on Fibonacci numbers to the exact minute.

Let me list the key times for the S&P 500 contract. Note that all times are East Coast time and must be adjusted for other time zones:

THE KEY TIMES

* 9:30 A.M.	* 9:43 A.M.
* 9:31 A.M.	* 9:51 A.M.
* 9:32 A.M.	* 10:04 A.M.
* 9:35 AM.	* 10:25 AM.
* 9:38 A.M.	

Although I was working solely with the S&P charts on the contract I was trading at the time, I was shocked to see how closely short-term, intra-day highs and lows often conformed to these key time periods. On one chart I observed an 80-point swing from one intra-day extreme of low to high in the four-minute period between 9:31 A.M. to 9:35 A.M. Looking out into the trading day, the day's high was registered at precisely 10:06 A.M. — two minutes off the predicted 10:04 A.M. turning point. On another day, two significant lows were registered at precisely 9:51 A.M. and 10:04 A.M. — both Fibonacci time periods. On yet another day, the low-to-high swing occurred from 9:38 A.M. to 9:43 A.M. And on still other days, significant intra-day highs and lows were missing the key times by one or two minutes. Could this be a coincidence? Or was there something to this time periods idea? Was there a pattern in the seemingly randomness of the marketplace?

This area of research deserves a much more thorough analysis than the cursory examination that I've made, but I suspect, like all good tools, this is one worth having in your trading arsenal.

Like any good tool, this one has the advantage of giving you the confidence to trade the market aggressively. By embracing the risk, rather than fleeing from it, you create the exact environment in which you can truly win. The paradox, as we've repeatedly pointed out, is evident. The safest time to enter the market is when it indeed seems most perilous — shortly after the open when one end of the range is most likely to occur.

THE "PARADOXICAL EVENT"

We've touched on the notion of the "paradoxical event," which is more fully explained in my book, Inside the Day Trading Game (TradeWins Publishing, 1995). The definition of a paradox, which is "an apparent contradiction which is nevertheless somehow true," goes to the heart of market action, especially in the opening moments of the trading session. This is the time when the market is most apt to do the exact opposite of what might be reasonably expected to occur. Where confusion reigns, opportunity — at least, for those who can "read" into the chaos — often lurks.

To understand this phenomenon, you must be willing to step back from the situation and perform a quick analysis of what is taking place. For most market players, the pit traders being the most notable example, the open is a time of intense emotion. Money begins to change hands and no one wants to miss the move. So what happens? The trend is perceived, for whatever reason, to be up or down and everyone jumps

on board at once. This means the pit may find just about everyone wanting to buy the market. Prices will quickly rise and soon more players will want to jump aboard this rally. When the last buyer buys and prices cease to rise, guess what happens? The swing will reverse and another trend — this time, down — will occur.

Sooner or later, of course, some sort of short-term trend may occur. But the point is, the imbalance in prices has typically found a number of traders off guard and now minus some of their equity.

How do you spot this phenomenon in action? Often, by the speed with which it occurs. Does it happen rapidly — and is there a bounce? Or do prices open low — and break lower? Or vice versa? The point is, a short-term trend on the open is often not the trend of the day. The other side of the coin is that this short-term trend may indeed be the day's most low-risk opportunity. There is a high probability that one end of the day's range will occur during the first hour of trading — and even in the first few minutes of the trading session. Armed with this knowledge, you can begin to look for clues that will position you for the first winning trade of the day. Specifically, you are looking for the following:

* A "paradoxical event" — namely, an open opposite to the prevailing sentiment and thinking.

* A follow through on yesterday's close — a higher open following a previous day's rally or a lower open following a previous day's decline.

* An opening gap placing pressure on prices to return back into the gap — the so-called "spring effect."

* Any excuse to "run stops" — a sure sign the market isn't going anywhere.

* The rare, but highly profitable, trending day which is essentially one direction the entire day.

* Volatility, as characterized by speed (time) and direction (price).

* Market "engineering" of any kind as explained by George Douglass Taylor's theory that the market is taken down in order to create selling for smart-money buyers — and vice versa.

Often, the "paradoxical event" suggests a relatively less risky trade that can be accomplished either at the open — or, at the very least, during the first ten minutes of trading. These are trades that can be taken near a day's high or low. Moreover, given the enthusiasm of the open, these trades are often profitable within the first ten to twenty minutes. These trades are indeed low-risk, because of the propensity of one end of the range to be registered in the opening minutes of a trading session. This is a paradox. While prudence might suggest waiting for a "true" trend to occur, the less risky trade is often taken during utter confusion and chaos. The point is, you don't "know" that buying will lead to a higher trend in prices or

selling will lead to a lower trend. But you do know that some trend, even a modest one, is likely to occur off the open and, given the paradoxical event, it is likely to be in the exact opposite direction of what everyone expects. Most traders want "proof" that the market is going higher or lower. The trader who understands the paradoxical event, on the other hand, embraces the uncertainty, knowing full well that the longer you wait, the more risky the undertaking.

WHEN CHAOS REIGNS

It is one thing to talk about the theory of trading and yet another to put your money at risk. The faster the game, the faster your money will vanish if you are not careful. I am reminded of a seminar I gave in Ft. Lauderdale a couple of years ago when we devoted Sunday to "theory" and Monday to "reality." Reality meant real-time trading. Since we were operating with live, real-time data, the idea was to closely approximate a real trading day. It was real, all right. Real hectic and scary, filled with the mishaps of normal trading — only worse. In looking back on that morning, I am reminded of the corollary to Murphy's Law ("Everything that can go wrong, will!"). The corollary is: "Murphy was an optimist."

First, the Dow opened down a hundred points. Or, at least, I thought it opened down a hundred. The fact is, it was a bad tick, but not wanting to miss a move, I jumped on the short side. By the time it was established that I'd received a false signal and faulty information on the market, it was too

late. The market was already soaring and I was short. No problem. I bought back the short positions at a loss and reversed direction — right at the top. The market began to swing back and forth like a roller-coaster. I took another leap — and realized my mistake. Three trades in a row had all resulted in immediate losses. I did what I had to do. I took the third loss and got to the sidelines. By that time, I realized my audience was beginning to lose faith in me, but I resisted the urge to be a hero. I did the only prudent thing. I admitted that I'd made a series of mistakes and that I was going to do the only sensible thing — wait until the afternoon trade kicked in after two o'clock. After some more post-mortems on the disastrous events we'd just witnessed, we broke for lunch. Waiting for the afternoon trade proved to be a brilliant move. We'll look next at the afternoon trade — or second opportunity the trader usually has to find redemption during the trading day.

FOUR

The Afternoon Trade

After lunch, we returned to the seminar room where our TradeStation program was projecting five-minute bar charts of the S&P 500 on a large screen we had set up in the front of the room. The turmoil of the morning had given way to a choppy sideways market which is often characteristic of the lunch hour. After some discussion of the hazards of trading volatile markets, both time and price began to reflect the beginnings of a clear-cut afternoon trend. I cautioned the class that the time had to be right for the afternoon trade. You didn't want to be premature for fear of getting whipsawed in the choppy market. On the other hand, even a moment's hesitation in jumping into the market could prove disastrous. We didn't want to end up chasing the market. We wanted to be on board when the trend began.

We placed four charts on the screen — futures, cash, premium, TICK. It was time to concentrate on what these charts were telling us. For one, although the cash held steady, the premium was being pushed lower and lower; this was a sure sign the floor traders were selling in anticipation of a decline. For another, the TICK — which measures the number of ad-

vancing issues versus the number of declining issues — was beginning to slip. The market was flirting with the lows of the day. I announced to the class that the bottom was about to fall out. There was no time left to observe the market. I grabbed the phone and sold five contracts at the market. The fill was predictably bad — a further indication that I had the right side. Within two or three minutes, the bottom fell out as the market plummeted 150 points straight down. At this point, the class because enthusiastic as they sensed that they had just witnessed some great fortune-telling event. Yet it was clear as day. The time was right and the market was ready to finally trend. My sell order hit the market just in the nick of time.

As panic selling drove the market lower and lower, our enthusiasm was indeed growing. That's because the class was already counting the money — which had amounted to several thousands of dollars — while I was concentrating on the price action. Where was this market going? I didn't want to leave a lot of money on the table. But I knew it was only a matter of time before the fortunate short sellers would soon be looking to take profits.

I had told the class how important it was to monitor the S&P cash price. So with each new low, someone would yell out, "new lows" and the excitement would grow. Maybe this five lot would turn into a $5,000 or $6,000 profitable trade — who knew? But just as a long-haul trucker sitting in the front row yelled out, "new lows" again, I knew the party was over. The premium had already started to rally — a sure-sign that buyers were willing to bid up the market to get out. I grabbed

the phone the hotel had installed to call the trading pit. It was dead! No problem. I dashed out into the hallway to a pay phone and excitedly dialed Chicago. "Buy me five S&P's market!" I yelled. The dead phone and 40- or 50-second delay in getting the order into the pit cost me almost $1,000. Murphy's Law all over again. Fortunately, the profits were still sufficient to offset the morning losses. I'd ended the day a winner.

After exiting the market, we'd examined what had taken place. A minute here, a minute there — all would have made a big difference. Although some of the class thought there was still opportunity left in the day, I explained that we'd seen the afternoon trend and capitalized on it despite the problem with the phone. The rest of the day was just a crap shoot — and indeed it proved to be, swinging back and forth as buyers and sellers fought over the remaining profits to be had. Both the high and low were registered for the day. The opportunities had come and gone.

This was the classic afternoon trade. Characterized by a trending market that was quick and pure prior to the profit-taking, the time elapsed from the entry to the exit couldn't have taken more than 25 minutes — and even then I was a critical minute late! Moreover, it demonstrated in a nutshell my philosophy about the market: namely, there are two trends a day — one in the morning, one in the afternoon — and that to capitalize on these trends, you must await the proper moment, jump in the market, grab the money and leave. That's exactly what I'd done.

Nevertheless, I still had reservations about the trade. Why

was I relying on the hotel's phone that has proven problematical? (Actually, I'd asked the hotel to install a phone line in the seminar room well in advance but they had managed to screw up the installation). Why didn't I "reach" for the bottom with a limit order when the market was breaking? Once the class began to think I had a sure-thing, of course, I knew I was on the wrong side. The crowd is always wrong. At any rate, I felt I had redeemed myself from the mishaps of the morning. The afternoon trade had worked!

WHAT ARE THE CHARACTERISTICS OF THE AFTERNOON TRADE?

The afternoon trade, unlike the morning trade, has a substantial intra-day price history in front of it and is apt to be shorter in duration than the morning trade. As we will soon see, timing in the afternoon tends to speed up at the rate of approximately two-to-one. Price moves that often take one hour in the morning, are often accomplished in 30 minutes in the afternoon — about twice as fast.

The afternoon trade may occur at a late-day confirmation and addition to the morning trade, but is apt to be initiated in response to new developments in the afternoon market. As a rule, the trends tend to be "purer" in the afternoon. This suggests the market has worked out cross-currents of uncertainty during the early part of the session and the true trend is about to emerge. The afternoon trade can be initiated as early as 1:00 P.M. to 2:00 P.M. East Coast time, but often the day's

true trend doesn't become apparent until after the bonds close (2:00 P.M. Central 3:00 P.M. East Coast time). The surest of the afternoon trades, however, can occur as late as 3:10 P.M. to 3:30 P.M. when the market enters one last pure trend on the day after terminating at the close.

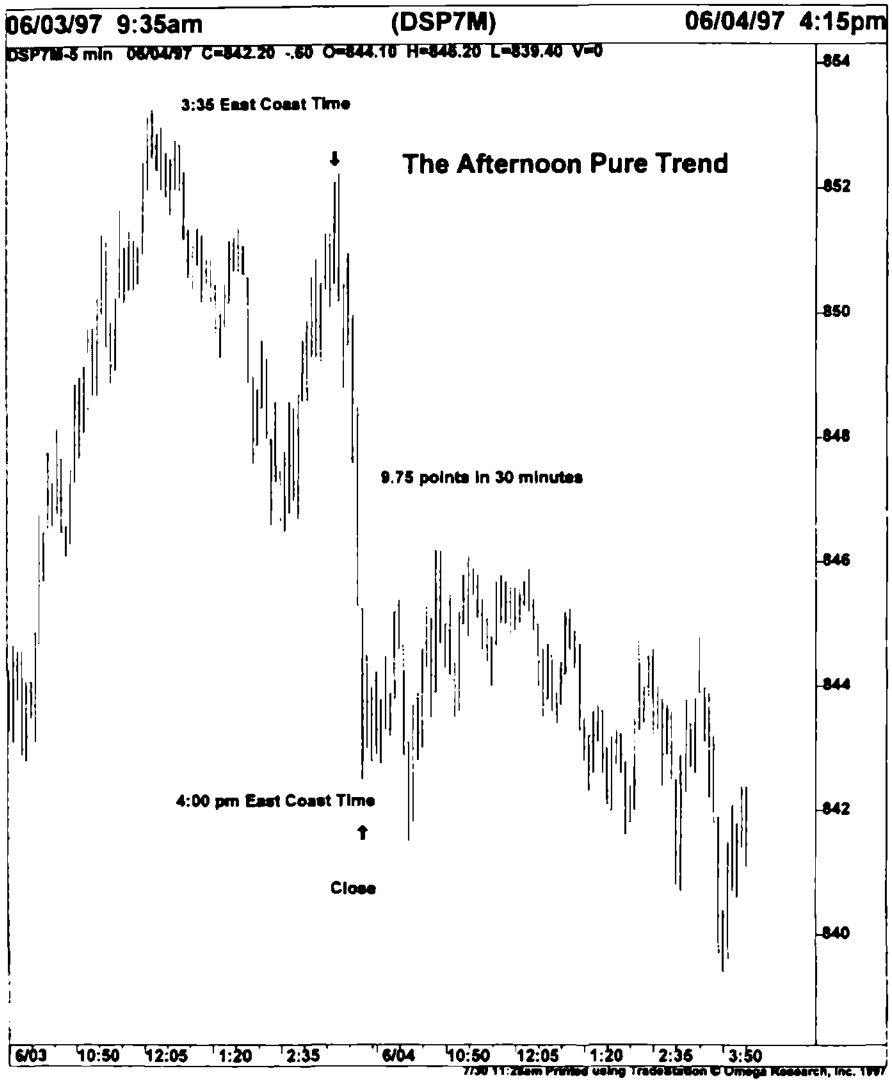


Chart #5: The afternoon trend is often the purest of the day. Here we have 9.75 points in 30 minutes.

The afternoon trade may or may not be related in a meaningful way to the morning trade. You can have a rally in the morning, sideways in the noon hour, and a continuation of the rally into the afternoon. Or the rally in the morning can give up all its ground in the afternoon — or vice versa. There is no one easily identifiable pattern to be found except this — typically, there is some sort of trend both morning and afternoon, or, lacking one in the morning, almost certainly in the afternoon. The afternoon trade is "surer" in the sense that a host of vital information has been incorporated into the market that didn't exist at the open. Typically, news reports have been released, the leading Dow stocks have registered their gains and losses, and the market has taken on a specific "tone" — mildly bullish or bearish or whatever. Add to this the performance of the bond market and you have something to grasp onto in terms of making a judgment about the stock market.

As with the morning trade, of course, timing is everything. Whereas the morning trade is often a "fade" of an early rally or decline, the afternoon trend is much more apt to be a buying in on a rally or selling of a decline. In short, the trend by the end of the day is already set. The upside of the afternoon trend is that the risk is often minimal. Since you are buying strength or selling weakness in a market which has already tipped its hand, the surprise factor is considerably lessened. This is not to say you won't encounter market adversity, however. Buying tops and bottoms can be a winning affair, but occasionally the trade will go entirely awry and you will be the possessor of a uniquely bad fill. Here, again, use sound trading skills. You can try to average up or down a

losing position, but time is vital — considerably more vital than with the morning trade because the close is approaching and you have nowhere to go if you are wrong. Since averaging prices should be tied to volatility, it is hard to suggest a good point to average in a losing trade. But let's say you sell "evens" and the market promptly rises to, say, the higher "half." It is often worth trying to sell more there. But you must do so with the knowledge that you are only going to risk another 40 or 50 points before you pull the plug on the entire trade. As a rule, the afternoon trade is much less likely to go negative than the morning trade.

One way to understand the psychology of the afternoon trade is to analyze the market players as the trading session reaches its conclusion. What happens as the close approaches? The losers are typically hoping for a miracle and the winners are smelling blood. This is a scenario for one side to panic, driving prices still further out-of-line.

Another way of looking at this is to consider the relative equilibrium or disequilibrium of the market. During periods of equilibrium, the buyers and sellers are engaged in a tug of war — neither really knows who will prevail. Yet as the final hour of the trading session approaches, chances are one side or the other will blink and show signs of relenting. This is when the trend will commence and prices will run. Prices might break, say, and there will be a modest rally as bargain-hunters rush in to bid up the market (i.e, bring it back to equilibrium). This might be followed by another break, however, and pretty soon you might have a rout on your hands. How, one might ask, can the market go lower from here? It might

have already had a 200-, 300-, or 400-point break. Yet this is precisely the point where the market is the weakest —after a sharp break, after the market has tipped its hand. At this stage, former bullish traders will turn extremely bearish. Now who will stand in front of the selling?

If you sell into a sharp break, you'll be selling into a vacuum. Panic — multiplied by thousands of selling orders —is what makes the afternoon trade so profitable. In recent months, we've seen the market panic on similar breaks drive the bid-asked "spread" to 100 points, what is known in the trade as a "handle." These panicky markets can yield enormous profits to a trader with the wits to stay with or add to a winning position.

Judgments about relative market value or "reasonable" profits are what causes errors in such markets. The tendency is to stand back in awe when such opportunities present themselves. This is a mistake. This is when you should be taking action. One is also tempted to take a so-called "safe," yet small, profit when the big opportunities present themselves —again, a mistake. The fact is, the market is <u>never too low to sell and never too high to buy</u>. Small profits won't help you when you have large losses.

Having said this, the bread-and-butter of the afternoon trade is simply what the market will give you in the final hour or half-hour of the day. On an average day, you can capture 80 to 150 points by finding the trend with <u>very little risk</u>! Because the risk is low, you can "trust" the trade. This gives you the confidence to take a significant number of contracts to make the profits important.

GETTING STARTED ON THE AFTERNOON TRADE

The place to start looking for the afternoon trade is to begin studying intra-day price charts. Whether you look at one-, five-, or 15-minute price charts is unimportant. The point is, you have to know that the trend exists. Go back over the past seven or ten days. Can you identify a trend of 100 to 150 points in the final hours prior to the close? Chances are, you can. Now make a note of not just the magnitude of the move but also the duration. Time and price. What are the characteristics of the move? Did they occur like clockwork as soon as the bonds closed? Was there a big push in the final minutes prior to the closing bell? Did they complete an earlier trend that first occurred during the morning trade? Chances are, even a cursory look will provide you with a pattern. Now you have something to work with. The reason that you need to do this investigatory work, as opposed to taking my word on it, is that you will be the one picking up the phone to take the trade. And you won't be able to do this unless you have confidence that not only a pattern exists, but that you have a reasonably good chance of capturing the move if your timing is right.

WHY THE TREND EXISTS

Knowledge is power. Once you understand why markets move as they do, you will be able to avail yourself of profits.

The S&P 500 futures market, as everyone knows, is driven by the relative values in the stock market, especially the underlying S&P 500 cash index.

Who moves this index? Primarily institutions. These are fund managers, including large pension funds, banks, brokerage firms, and the like. As a rule these institutional traders are conservative in nature. They don't want to be caught in cash when the market is rising. Nor do they want to be overly committed to stocks when a top approaches. But, after all, they have to do <u>something</u> with all that money at their command. And that's the point. What do they want to achieve? Simply to keep their funds on the favorable side of the averages. If the Dow and S&P 500 gain, let's say, six percent over a year's time, they want their funds to perform in a like manner. And here's why this is important: <u>they are herd followers: they don't want to miss the market</u>. So if we approach the final hours of trading and, let's say, the Dow is up 40 or 50 points, they don't want to miss the rally! They will become buyers. The trend begets the trend. Now, based on early buying, the market really has a reason to move up! This is the reason the trend often persists into the close.

In addition, as you probably well know, the major averages — the Dow, S&P 500, and so on — cease generating new statistics at the close of trading at 4:00 P.M. East Coast time, but the S&P 500 futures market continues to trade for another 15 minutes. This can be a critical time of the day because most traders expect follow through. Let's say the big fund manager couldn't get the prices he wanted to buy prior to the close. To protect himself from the market soaring

away from him, he may go into the futures market and buy S&P contracts. Now he is protected on the move up if there is follow through. And there usually is a continuation of the trend into the next morning. Here's why: overnight, market losers — namely, the short sellers — find themselves in a jam. The market is rising and they are short. Margin calls may generate some buy orders and others may be triggered on the open by stops. This all adds fuel to the fire. Sensing this prior to the close, the survival-minded shorts typically take their losses and run — another windfall for the fortunate buyers. Can you see how this can get very one-sided?

Given this tendency for the market to trend in one direction into the close, here's a rule:

If your position is profitable 15 minutes prior to the close, you can usually get a better fill getting out on a MOC order at the close. If your position is unprofitable 15 minutes prior to the close, get out immediately.

Do you understand why this rule works? The one-sidedness of the market leaves those who are on the wrong side no place to go as the close approaches. As a result, a mini-panic occurs each afternoon in the final minutes of trading as those on the wrong side pay up to get out. And what do they have to do to get out? That's right. Bid the market higher if they are short and buy back contracts. Or offer the market lower if they are long and sell to get out. A 60- to 70-point improvement in price is common in the final moments — a true windfall for the winning side.

This is also another reason why the MOC order works so well in this situation. Liquidity.

With many, many buyers and sellers in the market at the same time, you are much more likely to get a good fill than you would, say, five or ten minutes earlier.

For those who trade five or ten contracts at a time, the close can also be a bonanza. This is because the larger pit trader doesn't have the luxury of finding five or ten one-lot traders to take the other side of his trade. He is looking for size. And if your order is the right side, he will often give you the "edge" just to get out of his position.

TRADE DURATION

The tendency is to want to over-stay the market. This is a mistake. While you can have an entire afternoon of trending prices, or even an entire day, or week, the professional floor trader is much more attuned to the short-term trends. There are a number of reasons why you want to emphasize this short-term approach, but the most important one is that you <u>don't want to give back your hard-won profits</u>! Accordingly, try to concentrate solely on the market — and not the money. The money will take care of itself if you are correctly monitoring your position.

How long should you stay in the market? This is a difficult question to answer. Some trades persist for an hour or longer, some less. As a general rule, you want the trade to work soon after you enter the market. So there are really

three stages to the trade:

* the entry
* the move
* the exit

While the entry and exit can take seconds to accomplish, these are the most critical times of the trade. For you never know with certainty if you did the right thing. But there are guidelines you must follow at every stage.

1. The entry. Once you have made a determination to enter the market, you must have a checklist you will follow in monitoring the market. Here's what you need to decide:

— enter on a market order or limit order?

— time to monitor the position for positive movement — five minutes, ten minutes, whatever?

— anticipated Action Point (A.P.) or stop — what if the trade turns bad?

— anticipated profit level — where will you get out?

— quality of the fill price — does your bad fill mean you are probably right?

2. **The move.** Here you are into the trade and the jury is still out on whether you are going to emerge a winner. This is the time when a favorable move suggests you are correct, but you don't want to let down your guard. Initial fear can turn to confidence. Don't become complacent with the position. Do the following:

— chart the progression of the trade — are all signs favorable?

— track the indicators — clearly favorable? Unfavorable? Mixed?

— time — if 10 or 15 minutes passes and you are only marginally profitable, perhaps you should get out.

— track the premium — a rising premium late in the day can mean higher prices; a declining one, lower prices.

— activity — if the market goes dead after you get in, think about exiting on a limit order.

— track the pattern — the highs will be higher in a rising market; the lows will be lower in a declining market.

3. **The exit.** Not a time to be complacent. If the market trades at your anticipated point, it often helps to have a limit order waiting. At other times, the market will slide through your exit, suggesting continuation. Strive to buy on declines

and sell on rallies in exiting trades. Think about the following:

— does this trade warrant a MOC order — is the trend strong enough to indicate a MOC order?

— did you get a fast, windfall profit — should you nail it down and go in again?

— should you get out market or limit?

— does the price action warrant another trade — often 15 or 20 minutes prior to the close?

— are you getting out and planning to reverse — what is the evidence that tells you to do so?

— time and price patterns — where should the market go in how much time?

The difficulty rests with having accurate answers to these many questions in a short period of time. Often, a more in-depth analysis of the trade after the market closes will yield useful information. Perhaps you got out prematurely. Perhaps you overstayed the position. Perhaps you only traded two contracts when you really should have traded five. The important rule is that you use every trade as a learning experience. One valuable tool is to maintain a trading diary in which you analyze what took place during the trading day.

One thing is certain: you will continue to make mistakes. Just make sure they are not the unwarranted type of mistakes which could have easily been avoided with a little thinking and discipline. Your goal is to make money — not pick the high or low of the move. A profitable piece of the move will stand you in good stead over a profitable trading career.

Here's a general rule for the afternoon trade in terms of duration:

Ninety percent of all profitable afternoon trades will take from 15 minutes to one hour. On occasion, you will have a winning trade that captures 100 or more points in less than ten minutes, but this is the exception. The trades that take longer than one hour occur on trending days when you don't want to exit until the close.

USING PRICE ACTION TO IDENTIFY THE AFTERNOON TRADE

As a day-trader who specializes in the S&P 500, I know that nothing is more valuable than the futures price in determining where the market is likely to go. I know that fundamentalists swear by supply and demand analyses. They have a valid point — long term. But when it comes to trading the market short-term, the technical — really, the psychological —factors are much more influential. For this reason, you have to learn to look at price as the sum total of opinion on the market at one moment in time.

How you do know where prices are going? You don't.

But this shouldn't stop you from trying to make sense of the market. With practice, you will find your winning percentage improving.

A word of caution: **to be consistently successful in finding good afternoon trades you must be selective. This means you will not have a signal every day. On average, if you can find three good opportunities a week in the afternoon trade, you will be well rewarded.**

Why this warning? Good trades are hard to find. While it is true that the market will typically move everyday, you are doing yourself a disservice to think that you should be able to capitalize on every move. You simply cannot capitalize on every opportunity without exposing yourself to an inordinate amount of risk. Remember, you are trying to manage the risk. This requires incredible discipline and concentration as well as courage. As soon as you allow any one of these elements to slip, you are asking for trouble.

As with the morning trade, the afternoon trade is often telegraphed by initial price action. That's right. The market will <u>tell you when it wants to move higher or lower</u>. How? Through price action. By definition, new highs have to be made in order for the market to work higher; conversely, new lows will have to be made for the market to work lower. The problem rests not with identifying new highs or lows being made, but knowing <u>when the move is the real thing</u>. We've all seen false moves generate bad trading signals.

To formulate a rule, you have to take into account market volatility as well as overall price level. Several years ago, when the S&P traded at one-half today's level, the meaning

of a price move in terms of the overall value of the underlying S&P contract was a higher percentage of the value of the average than it is today. The same is true of the Dow.

Remember when a 40- or 50-point move in the Dow was a large move? Today, we can have three or four larger moves in a single week. The point is, values are relative.

Having said this, we all know the 50- to 75-point moves in the S&P over a period of a half hour are relatively meaningless. But 300- or 400-points over the same period of time is significant. The market doesn't move from price level to price level without reason. A move of this magnitude is significant and calls for a **trading signal in the same direction of the initial move on the first opportunity of a countermove.** Put in simple terms, a price break signifies a sell position on the first rally, a price rally signifies a buy position on the first profit-taking break.

The tendency to not capitalize on this opportunity presented by the afternoon trade is caused by several factors:

* you think you "missed" the trade (not true)

* you think selling into a decline or buying into a sharp rally is a mistake (it can be)

* you think it is too late in the day to make any good profits (not if you have at least 15 minutes left in the trading day)

* you don't "understand" why the market is trading at

this level (you are thinking too hard)

* you simply don't know where to get in or how to manage the trade once entered (this can be learned)

REVERSING IN THE AFTERNOON TRADE

We've mentioned that one way to turn losing trades into winning ones is to reverse direction when you are wrong. To do this, however, you must be prepared for this eventuality in advance. You cannot be 100 percent correct on every trade — no one can. But if you manage your equity properly, you can keep funds in reserve to help you reverse without worrying about the money.

Most traders lose because they are under-financed. The best traders are not under-financed. The under-financed trader tends to give up easily. The properly-financed trader is realistic and treats losing trades as a part of the game — and a challenge. With sufficient practice, you will find that reversing — and other strategies calling for an aggressive approach — become second-nature once you incorporate them into your trading plan.

What must you know to reverse successfully?

First, you must be aware of the whipsawing day when virtually nothing you do will work.

Fortunately, such days only occur approximately one trading session a month. Since it is not always easy to identify this type of day before it ends, you should simply be aware of

its existence. My rule is to reverse no more than three or four times unsuccessfully before calling it quits.

Second, you need to adopt the stance that you really don't know where the market is going. This will free you of the opinions which can prove so costly. The easy approach, in which you take a position and place a stop, often doesn't work in the market. Too many things can go wrong. You need a less rigid, more fluid stance in the market, one that embraces the possibility that market conditions can — and do — change, often rapidly.

Adopting this attitude is probably the only real chance you have to succeed at this demanding business. Unless you are prepared to see yourself go through a certain amount of time with a reasonable amount of money at risk, chances are you aren't going to succeed. The market, and indeed life, is not set up so that totally neophyte, non-professional traders, with little or no training, step up against experienced professionals and win! Indeed, for the new trader to have an initial success in the market is probably one of the worst things that can befall him.

Now, why does the afternoon trade offer an excellent opportunity to win? Because the trends in the afternoon tend to be purer than those in the morning. There is less market "static" where confusion among buyers and sellers results in wild gyrations. In addition, markets don't tend to go "dead" in the afternoon. On the contrary, the likelihood of some type of trend emerging just prior to the close is high. Lastly, as we've already mentioned, the market action tends to speed up as the close is reached; thus, you are likely to be able to

reverse and quickly regain your losses — and more. So the afternoon market provides you with exactly what you are looking for — a pure, fast trend!

DOUBLING ON THE REVERSAL

Because the final thrust on the afternoon trade tends to be the purest, the probabilities favor a profitable outcome. Accordingly, if there was ever a time to double-up on a trade, this is the time to do it. The key component is speed — you simply cannot wait for the trade to prove a winner. Having taken the initial trade without success, you now must double the number of contracts on the reversal.

The advantage of doubling, of course, is that you only need half the market movement to recoup the prior loss. So if you lost, say, 60 points on a two-lot, you only need 30 points on a four-lot to get even.

Why not double on every reversal? Not a good idea. Some trades require more prudence, since the probabilities are apt to be different. But in the afternoon trade, with the close approaching, you often have an ideal situation for doubling. You don't want the market dying on you once you reverse. The psychological pressure increases when you double on the reversal. Now you are risking twice as much money on the heels of a loss — and you may be throwing good money after bad. The demands are great; concentration is required — does the market really want to trend higher or lower?

One thing you must do is act quickly. The longer you

wait to reverse in the afternoon, the more precarious the situation is apt to become. Let's say you were long on the initial entry and you lost a quick 90 points. Note the speed with which the loss occurred. If it happened quickly, chances are the market is telling you something. It wants to go lower in a serious way. The tendency for many day traders is to waste time thinking about the loss — especially the money. This is a mistake. You must not think about the money! Rather, you need to sell out the long position and then go short in anticipation of a bigger break. The market is never too low to sell and never too high to buy. Indeed, the very best trades result from selling weakness and buying strength.

Don't take my word on this. Examine the price action in the final hour of trading. The more charts you look at, the more convinced you will become that doubling on the reversal actually works. Once you try this strategy on paper, however, you must be prepared to translate this knowledge to the market. This is where the real art of trading occurs. To succeed at this strategy, you must be willing to double-up and reverse without hesitation.

EXITING THE REVERSAL TRADE

The tendency is to grow quickly euphoric once the reversal move begins to work. This is a mistake. For one, the market doesn't know — nor does it care — that you've had the good fortune to switch sides. What is given is often quickly taken away in the market. So you must have a plan to exit on

the first sign of the reversal going sour.

There are some guidelines you can look for in getting out of the afternoon reversal trade. Ideally, the market will trend into the close and you can exit MOC. This is the easy way. But often the market will not cooperate with you and that's when you need some rules for exiting the trade. First and foremost, you have to return to the time and price rule. Where has the market come from and how long has it taken to get there? There are several ways to approach the dilemma of exiting the market — none of them having anything to do with <u>your</u> position. The point is, where is the market going? Not, "what's the status of my equity?" Look at price. Has the market just broken 200 points in 40 minutes? Now, you have something to work with. You take an identifiable intra-day high and intra-day low and measure the difference. Next, you look for another intra-day high or low to work with. Perhaps, the next intra-day high has failed to reach the prior high. You don't have a low yet because the market is still trading. So you <u>project</u> a low by taking the prior move — 200 points — and subtract from the recent intra-day high. There's your projected low. And that's where you take profits!

By using this strategy, you are dealing with the market as it exists — not as you would like it to be. Everyone who is short would like the bottom to fall out just as every long wants the market to soar. But the most important question concerning where the market will go in the short-term is: where has it been recently?

The same is true of time analyses except with this provision. When you approach the close, everything tends to speed

up. Indeed, the velocity tends to increase by a factor of about 100 percent, or you could say the speed tends to double. So what took approximately 40 minutes to occur earlier in the afternoon, or morning, now takes just 20 minutes in the final hour. Now, there may be a period of time when the market stays relatively stationary prior to the final break. But this is just the calm before the storm, as restless bulls and bears try again and again to fashion a move. But once it comes, watch out! The ensuing break or rally will occur rapidly.

As a trader who has doubled on the reversal, you no doubt will find your emotions whipsawed with every counter-current in the market. The point is, don't become complacent. When the market goes your way and the move is complete, you <u>must exit the market immediately</u>!

Not to exit on this move sets up serious problems. For one, the market is apt to mount a strong counter-trend. Why? Because the forces that initially pushed it higher or lower have been spent. Ask yourself this: why did the market suddenly break so fast? What made it move? Well, one scenario is a lot of stops and a lot of fellow traders wanted evidence that the market was going lower before selling. Once the market breaks, all the sell stops have been purchased by bargain-hunting buyers. So there are no more stops down there. Moreover, the new short-sellers, seeking a "sure-thing," are about to become reluctant, but panicky, buyers in the event the market rallies. This is why the market can turn so quickly!

Try to identify the trend and calculate when and where it will end. At the culmination of the trending action, you must take the money and run.

SUMMARY

The afternoon trade takes advantage of the purest trend of the day — the one into the close. Unlike the morning trade, the afternoon trade has an important price history that often highlights the direction and magnitude of the move. The afternoon trade also lends itself to an aggressive reversal trade should the initial entry not prove profitable. On trending days, the afternoon trade can be extremely profitable, because whatever was gained in the morning is often duplicated in the afternoon — and sometimes more. The afternoon trade, at least when applied to the S&P 500 futures market, does not compete with other markets, since the bonds close one hour and fifteen minutes before the S&P close. While the profits are limited to what the market will provide in the final hours of a trading session, the afternoon trade has the advantage of relatively low risk. With the remaining time limited, the afternoon trend can be exploited aggressively. Typically, this approach is what wins the game — a sound entry and immediate follow-through. Finally, users of the afternoon trade can become sufficiently comfortable that they are willing to risk a substantial commitment on trades that have a very high risk/reward ratio.

FIVE

The Close

When it comes to discussing the close, much of the same points that were so important at the open also come into play. Remember that the market is a fluid, changing phenomenon whose secrets cannot be easily discerned. It is precisely because the market is ever-changing that easy formulas and pronouncements are difficult to make, although most of us would much prefer the simple answer. Nevertheless, we know enough about the close to make a couple of important observations. For one, like the open, the liquidity is apt to be excellent. With many buyers and sellers all competing for the best price, chances are we will receive a good fill. For another, given the time restraints, chances are market panic will drive the market to an extreme, resulting in a windfall for those on the right side.

THE EXTREME END OF THE RANGE

Like the open, the close is apt to be at the extreme end of the range for the day. This propensity of the market, to trade

at an extreme in the final minutes, is the rationale for why the afternoon trade can be so profitable. Indeed, in a trending market, the day's high or low is often registered in the final minute! I've seen this happen many, many times in the last ten years. The exception to this is when the market is not trending (such as a pause day following a big rally or decline, when the market stops to regain its breath). Also, once the market reaches it price goal for the day, in terms of time and price calculations, it is apt to retrace back to the middle.

The implication of this tendency should be clear: exit at or near the close when you have a winning position. For those holding losing positions, the opposite is true: get out or reverse heading into the close.

HIGH VOLATILITY

Here again, like the open, the close offers considerable price action — with both opportunity and risk. One-hundred points in the final ten minutes of the day is not that uncommon in the S&P 500, and it can translate into very substantial, quick profits. But unless you are aware of some of the pitfalls of trading into the close, you could be making a very significant mistake if you treat every close the same. In some markets, exiting on a M0C order can be the wisest trade of the day. But in others, you are asking for trouble if you think a higher trending price suggests a higher close. This is especially true late in the year, when the big stock players are looking to dump stocks into strong markets. One big order in a thin market can spell panic.

WHAT HAPPENS ON THE CLOSE

If you are to understand the dynamics of the close — and how it impacts the afternoon trade and even tomorrow's open — you need to understand why and how the major players are reacting to the closing prices. The professional floor traders have a single mind-set about the close: they don't want to go overnight with open positions. Whereas the typical public trader isn't afraid to go overnight, the floor trader sees it as both extremely risky and somewhat foolish. For one, the floor trader knows that 500- and 600-point gap openings are not uncommon. This could mean ruin to some traders. The floor trader operates in an environment in which commission costs are not a factor (he is often paying $1 per round-turn or less). Moreover, the floor trader knows that his livelihood depends on not making stupid mistakes. The public trader, on the other hand, is apt to throw caution to the winds, since he often has no idea how risky the futures market can be. As a result, the floor trader is exiting the market at the close regardless of the price. The public trader may or may not exit, depending on whether he thinks he'll get a better price in the morning or overnight market.

This divergent point of view sets up a situation where the public trader can often get a good fill. This is especially true if a large local is looking for someone who will do "size" — ten or more contracts. Because rather than get out of the ten by doing "two" or "three" with several traders, the local would rather exit with one 10-lot trade. To do so, he will often give up the "edge" to the public trader — one of those rare occa-

sions where the public actually profits at the expense of the floor. This is most likely to happen if you are right about the market, of course, and he is wrong. This is where a MOC order really pays off.

We know that there is considerable liquidity at the close — indeed, the market probably enjoys greater liquidity on the close than at any time during the entire session. This creates a favorable trading environment in which the fills will be close to the bid and ask prices and there will be little slippage. But what is really happening at the close? The market is attempting to reach some sort of equilibrium price — what I call the "value area." The close is important in this sense, because it represents a price or range of prices at which the market will typically return in the following session — and perhaps in the session after that. Indeed, the chances are very high that prices will return to the previous day's close. This, again, is another reason why professional floor traders have no need to go overnight with a trade.

In our discussion of the gap trades, we observed how a gap opening will often be "filled" — the classic counter-trend opening move. There is another side to this notion of the close representing a magnetic attraction to prices in the following day's session. And that is: when prices move <u>away</u> from the prior day's close, they tend to suggest a trending action. This means you can typically buy strength or sell weakness as the market moves away from the value area as represented by the prior day's close.

A corollary to this idea of the market gaining strength or weakness as it moves away from a closing price is the notion

of the market stalling out as it moves a moderate way above or below the closing price. Of course, prior to the close, you must work with something other than the actual close. And here's where the idea of a value area is important. If, over the course of, let's say, a two-hour period prior to the close, the market trades in a narrow range of perhaps 80 points, chances are the market is going to close within the 80-point range. Accordingly, a judgment can be made suggesting that you trade the counter-trend, selling the rallies and buying the dips. The proof of the validity of this strategy is the occasional foray upon the stops above or below the market. Here the market will go into new high or low ground — but only momentarily — and promptly retreat back toward the middle. Here the rapid price rejection is the key that the market isn't going anywhere.

HOW TO DETERMINE THE CLOSING PRICE

Trying to determine the closing price is an art form that every trader should try to master. Although market opinions are not usually helpful (you can easily grow exceedingly enamored of your opinions), this is an exercise that, practiced over time, can stand you in good stead when it comes to taking profitable positions. We know from our previous discussions that recent market history is the best indicator of whether a market will run. Ask yourself: where has this market come from? And, secondly: where is it headed? We know that the time of day is important. So any attempt to forecast the clos-

ing S&P price or value-area range shouldn't come before 3:00 P.M. East Coast time.

The most reliable method of determining the closing price is by using price and time measurements. If using an intra-day afternoon low, look for an area of price congestion, especially an area where closing prices on one- or five-minute bars were identical. Typically, this is an area of congestion around which prices will oscillate. If the afternoon trend is good, this will signify the half-way point with the move good for another 50 percent. For example, if the first area traded in a 75-point range, the market is probably good for another 75 points by the close.

Even when prices reach their intended target price in the final hour of trading, buying or selling panic is apt to drive them to an extreme by the closing bell. This is why the MOC order is often the best way to exit a trade that is capitalizing on a late afternoon trend.

* **when the afternoon trend is counter to the morning trend, the range often retraces the entire morning range**

* **when the afternoon trend is in the same direction as the morning trend, the respective "legs" of each move are often identical**

* **when you have a trendless day, the close is often in the middle of the value area**

Again, don't take my word on this. Study the price action of 5-minute price bars and see whether you can identify these patterns.

IMPLICATIONS OF THE CLOSE

A strong close suggests a higher open in the next trading session — one which often can be "faded." This is the setup for Taylor's short sale day pattern (high made first; low made last). In trending markets, of course, a strong close suggests still higher prices to come. In such a market, buyers tend to push the market higher at the close when they anticipate bullish events in the coming sessions. A weak close suggests the opposite — lower prices on the open followed by a rally (the classic, low-made-first Buy Day pattern). Here, again, a declining market will continue to trend lower without the bounce. The point is, the type of market you are trading is important.

Here are some more good ideas to remember concerning the close:

* **The close often occurs at an extreme, making the MOC order a good one <u>if</u> you are on the right side of the market**

* **Like the open, the close is characterized by excellent liquidity — providing you with a fair price**

* **To be a day-trader means you must exit the market by the close**

* **Today's close can be used to determine whether tomorrow is a trending day or non-trending day — depending on early morning price action**

* **When the day has been trendless, the close is apt to fall in the middle**

* **You can often forecast the closing price by using time and price measurements**

* **Look where the market has come from to determine where it will likely close**

SIX

Support and Resistance — The LSS 3-day Cycle Method Approach

For more than ten years now, I've been analyzing, writing and speaking about LSS, the trading system I developed in the mid-Eighties based on Taylor's "Book Method." So far, we've devoted our discussion to time and price — the notion that if the market trades a given magnitude in a fixed period of time, it should be capable of duplicating the scenario over a similar time span. This was the brilliant contribution of the legendary market analyst W.D. Gann. The other side of the time and price coin, however, is market analysis based on support and resistance, the area of research which George Douglass Taylor explored. Since LSS is based on Taylor's work, I suspect an examination of this approach dovetails with our earlier discussion.

Because I've written extensively on the LSS 3-day Cycle Method, I don't want to cover too many of the basics here. But I do want to demonstrate how this notion of support and resistance, combined with time and price, offers the trader an opportunity to identify and capture some of the best trends during the day.

In a nutshell, Taylor maintained that markets will trade in the path of the least resistance; and, when the forces become too one-sided, market direction will change and trade until the path is once again blocked, reversing again. Moreover, he identified these forces as operating in a three-day pattern characterized by a so-called buy day, sell day, and short-sale day. Since buy means to be "long," I've taken the first letters of these three days — long, sell, short sale — and called my version LSS.

A dramatic shift has taken place in the futures industry from the grain markets of the nineteen-fifties to the high-flying financials of the nineteen-nineties. Taking note of this transformation, I've tried to analyze the 3-day cycle in greater detail. Due to today's volatility, like most traders, I've become much more short-term oriented. Indeed, one observation I've been able to make is that a 3-step, intra-day cycle seems to exist on a daily basis. There are often complete cycles during the day when the market begins at a low, trades higher and stalls out, and finally makes a new high and returns back to its original opening price — the complete 3-day cycle compressed into a single trading session.

Taylor maintained that the market was "engineered" from within to drive money out of the hands of weak market participants and into the strong hands. This is another way of saying that the rich get richer and the less-well-informed suffer losses from buying or selling at the worst possible moment in time. This is exactly what occurs on almost every market day in the futures markets. The knowledgeable few make the money while the vast majority enter the market,

lose money and leave — only to be replaced by newer and less-informed investors. Then the cycle repeats.

As part of the "engineering" that Taylor observed, there is a seemingly 3-day or, as we shall see, 3-step cycle. The market tends to be taken down in order to shake out of weak hands the commodity or futures at advantageous prices to the strong hands. Having been taken lower, the market then rises. This, in turn, creates buyers and sellers at the top comprised of the same two groups. But here, the strong hands are selling and the weak hands are buying. This in turn gets over-done and the market retreats — and the pattern is repeated.

Anyone who has ever sold near the low of the day or bought at the top knows the disappointing feeling of being the "victim" of one of these engineering exploits. The problem is, what can we do to capitalize on this tendency of the market to trade in cycles?

Certainly, we can become aware that these market cycles exist. Look at daily charts with the open made near the low of the day and the close made near the top. This is the classic buy day. Next, observe how the market often opens steady to higher on the second day and trades up — if only momentarily. This is the sell day. And, finally, look for the high made first shortly after the opening of the third day, a day when the market sells off, closing down near the low. The classic short sale day. In a nutshell, that's the three-day cycle. While it may vanish for a day or so, requiring the cycle to be rephased, the pattern tends to repeat.

DRAWBACK OF THE ORIGINAL LSS

Ten years ago, when I originally began studying the 3-day Cycle Method, the market was poised for a major bull move — which has since materialized. Much of the initial research, however, was done on a stationary, non-trending market — one in which the market would rally one day only to retreat the next. This trading environment was ideal for LSS because we used a simple overbought/oversold indicator to detect bullish or bearish sentiment in the market. As a result, when the market became overbought, we sold; when it became oversold, we bought. It was a simple concept and one that worked fine in a choppy market. But if the last decade has taught us anything, it is that the stock market can — and will — make tremendous swings over a period of time. Accordingly, the last thing you want to do is sell into a bull market or buy into a declining market. Witness the 1987 stock market crash, to name just one extreme example.

To resolve the problem of getting on the right side of the market, we have introduced a simple oscillator that, hopefully, keeps us from buying in a bear trend or selling in a bull trend. This feature of the new LSS system makes it much, much more flexible — and profitable — than was the earlier version.

In addition, the earlier LSS was designed for one market alone — the S&P 500 futures market. Over the years, I've heard reports that LSS works on the soybean market, or the currencies, or the pork bellies. So we have researched other markets. The LSS software now runs on nine different fu-

tures contracts.

Lastly, the original LSS required that data be inputted into the computer manually. With the introduction of inexpensive modems and a variety of data services, we have improved the software to collect the data at day's end and do all the calculations automatically for the next trading session. This is a big improvement on what we were capable of doing ten years ago.

THE NEW LSS SOFTWARE

The new LSS software, which is based on the notion that time and price will form a coherent pattern with support and resistance, was tested on tick data going back to 1987.

Although we tested some 30 futures contracts in all, the finalized version runs on just nine futures contracts. They are: the S&P 500, U.S. Treasury Bonds, Swiss Franc, Deutsche Mark, British Pound, New York Composite Index, Silver, Copper and Coffee. As mentioned above, the software relies on a modem to capture the day's open, high, low, and close. Since it runs on DOS, even users who don't have Windows can run the program.

In real-time performance, the software has maintained its winning percentages with the coffee outperforming all the contracts, although each market contributes to the overall bottom line.

We maintain a comprehensive history of all of the system trades. To obtain an up-to-date disk containing the trading

history, contact me at the following address:

George Angell
P.O. Box 6251
Key West, FL 33041-6251
(305)292-7775 voice
(305)292-1257 fax

The new software does not require live data to trade nor do you have to watch the market constantly. Rather, the software provides as many as five daily trading signals. Of these, no more than three signals will typically be hit on a given day, often just one or two. On average, of the nine futures, you have two to three trades per day. All positions are protected by a trailing stop-loss order; entries which are not stopped out are liquidated on the close, since no positions are held overnight. The average winning trade is approximately twice as large as the average losing trade. The system has averaged between $7,000 and $14,000 per month profit on one-lots, with just two to three entries per day for several years now.

In addition to providing trading signals, the new software maintains a daily chart for each market, including a bar chart highlighting the so-called "anticipated range" alongside the "actual range" for comparison. The software also displays the buy and sell envelopes, including the buy and sell numbers. A chart of the moving average of the daily overbought/oversold oscillators is also included.

THE BASICS OF LSS THEORY

We've covered some of the basics, but let me summarize as follows:

* A three-day pattern exists in the market, and often this three-day pattern appears as a three-step pattern on an intra-day basis.

* When you can identify this pattern, you will find that the market is taken lower to go up (buy), rallies and stabilizes (sell), and is often taken higher one last time (sell short) prior to declining.

* The pattern has the effect of driving out the weak hands (stops) by the strong hands (stop runners).

* The entries can be mutually exclusive or can result in averaging, depending on the volatility of the market.

* Clear-cut support and resistance zones are identified by measuring recent rallies and declines.

* A new oscillator based on a daily overbought/oversold sentiment indicator is useful in keeping you on the right side of the market.

* If you study the "anticipated ranges" versus the "actual ranges," you will see how accurate these LSS measurements can be.

* The average range measurement can be used to forecast daily highs and lows by utilizing the intra-day high and low.

* You trade at a disadvantage if you are unaware of the LSS cycle.

DETERMINING SUPPORT AND RESISTANCE — THE TREND REACTION NUMBERS

Floor traders swear by these numbers. So you'd better know them if you are going to day trade futures. The conventional thinking is that prices will bounce off these support and resistance numbers. There just might be enough like-minded people to make this very anticipated bounce occur. Like any mechanical approach to the market, however, you must use them with reason. The market trades from level to level. Once a key support or resistance is broken with no retracement, you'd better join the crowd in looking for the next stopping place. Nevertheless, you'd be surprised how valuable this simple formula can be in the market. With that in mind, here's the formula:

$$\frac{\text{High} + \text{Low} + \text{Close}}{3} = X$$

$$2X - \text{High} = \text{Buy Number}$$

$$2X - \text{Low} = \text{Sell Number}$$

For example:

Assume the following:	High	=	664.20
	Low	=	655.90
	Close	=	656.00

Therefore:

$$658.70 = X = \frac{664.20 + 655.90 + 656.00}{3}$$

$$2X = 658.70 \times 2 = 1317.40$$

$$1317.40 - 655.90 \text{ (low)} = 661.50 = \text{Sell Number}$$

$$1317.40 - 664.20 \text{ (high)} = 653.20 = \text{Buy Number}$$

THE AVERAGE RANGE

The Average Range is an important concept in LSS. The formula for the average is simple: You take the daily range (high - low) over a period of ten consecutive trading days and divide by ten. The average range number is used for a number of calculations, including stop placement. The average range can also be used to generate a Target Buy or Sell Number by taking an intra-day range (after one hour of trading) and adding to the intra-day low or subtracting from the intraday high. This number can be quite valuable in making intelligent decisions concerning support and resistance which is at the heart of the LSS system.

To avoid confusion, let me explain the difference between

the average range and the anticipated range. The average range is a ten-day average of the ranges. The anticipated range is the difference between the buy and sell numbers, which themselves are averages of the four numbers that comprise the buy and sell envelopes respectively. The buy and sell numbers which are generated by the trend reaction formula are merely one component of the four numbers in the buy and sell envelopes.

Futures traders love numbers. But the real art of trading requires that you use them with discretion. One way the LSS system uses the average range is as a filter when the market gets overwrought. Essentially, the system filters out certain trades when the average range reaches a level where the risks outweigh the rewards. For instance, if we know going into a trade the percentages are, say, 70 percent to win, then there is a nearly one-third chance of losing. If the risks of the stop being hit are too high, or unacceptable, given our insistence on minimizing risks, the system will throw out the trade. This will result in a "Pass Day" designation in the trading signal column on the following day. The alternative to using the average range as a filter, is to subject our software buyers to excessive risks. We'd prefer consistent, long-term profits — albeit somewhat lower profits — to huge swings in the equity. This is especially true when a new buyer is just starting in his use of the software. Nevertheless, we suspect that there are traders out there who will embrace the higher risk; hence, we provide an "aggressive" signal as well as a more conservative approach. The user simply has to indicate to the software program which mode he'd prefer.

The point being made here is an important one. It is not what you make in the futures market, but how much risk you endure to win. That's why so many "highly-profitable" trading systems don't work. They are un-tradeable. Chances are, on paper they make big money. But the trader who must continually throw good money after bad in the system's drawdowns won't be around for the winning trades. It is for this reason that the bottom line is not the most important thing in considering a system. Rather, focus on the drawdowns, the win-to-loss equity ratios and the slope of the equity curve. These things are far more important in designing a winning system. There are a lot of systems that make money. But a lot of them are not tradeable.

THE VALUE AREA

LSS operates on the notion that there is a so-called "value area." This is a price area where prices tend to be in equilibrium, where buying and selling results in price consolidation. The area around the close tends to be a value area, or the price around which prices gyrate during the noon hour. Users of Market Profile are well aware of this notion, since prices rotate back and forth around the value area. It is represented by the area where most of the trading takes place on a non-trending day. This area typically appears as the thick part of the bell-shaped curve so well known to Market Profile analysts.

To understand how the value area works you have to view

it as a giant magnet, or perhaps gravity. As prices trade above or below the value area, natural forces — much like a magnetic force or gravity — pull them back toward the middle. Yet when prices move away from the value area, a paradox occurs. Further away, they are less influenced by the value area. Like a space capsule leaving the earth's atmosphere, prices are no longer subject to the gravitation forces once they get into outer space. The same appears to be true with futures prices. The implications of this tendency of prices to behave similarly to a space capsule suggests, once away from the value area, the market is free to trade at significantly higher or lower levels depending on the direction of the move.

We capitalize on this propensity in LSS by using a zone pattern that identifies the probabilities of the market trading from one level to another. For example, let's say today's open is close to yesterday's close. What does this tell us about the market? Typically, that buyers and sellers are in equilibrium and that the market is experiencing stability, since both buyers and sellers are both willing to exchange contracts at roughly the same price. For someone who wants the market to move, however, this state of equilibrium is not an encouraging one. How can you make money in the market if it doesn't move? What's more, given the current supply-demand equation, it is unlikely the market will trend one way or another. So what does the system tell you about current conditions? That the best course of action is to remain on the sidelines. No action. With LSS, we have a potential for approximately five signals on nine futures a day. That translates into 45 trades the next day. But the reality is that we

rarely get more than three or four trades a day. The reason is the entries are placed away from the market where the probabilities of a successful trade are most likely to occur.

Another way to look at this is to say, there are two directions the market can take: back to the middle or to a new value area in another equilibrium zone. The fact is, the market trades from level to level and then it spends time at that new level until supply and demand forces propel it off to another level. To complicate matters a bit, there are levels within levels. And that's where all the sophisticated analyses concerning support and resistance zones come into play. The shorter-term your outlook, the more likely your numbers will be more finely honed. Witness, for instance, the scalper who will immediate sell the offer, knowing he will probably be able to cover by purchasing the bid. His time frame, like his profit, is constricted and limited. Taken a step further, a slightly more far-reaching trader will sell the rallies all day in anticipation of the market returning to the support area where he can cover at a profit. Sooner or later, this strategy, no doubt, will prove unwise and he will scramble to cover — usually at a loss. For at that point, he knows his game is up and the market is about to trend — where, chances are, it will again begin to churn back and forth and he can yet again begin selling offers and buying bids.

For the LSS trader, the focus is more on correctly positioning the trade to capture the day's trend. So I am looking for the market action to tell me the probabilities have now shifted in my favor so I can take the trade immediately. Remember, the window of opportunity in trading can be as short

as several seconds to perhaps even an hour long. But once you have taken the trouble to do your analysis (which the LSS software performs for you during the previous evening), you must be prepared to act. Knowing where the market stands in terms of the value area, therefore, can prepare you to discover some excellent trading opportunities.

Traditional technical analysis places a lot of emphasis on the value area, which is really nothing more than the point between support and resistance where the market trades. In the nomenclature of the Market Profile analyst, the market will "rotate" back and forth between support and resistance, but always creating a counter swing every time it gets out of line. Fortunes are won understanding this concept. The move toward the value area is a powerful one. This is why so many traders are surprised when the markets gets "out of line," but doesn't return to the middle.

Take the example of the gap opening — a classic case where prices have a strong attraction for filling the gap. The traditional tactic is to "fade" the gap and profit by the move back to the middle. This is true even if the market's ultimate goal is to go in the direction of the initial move. Yet there are exceptions. Consider the gap up in a strong bull market. If you fade that move, chances are you will be caught in the short-covering panic when the market screams higher. We've discussed this phenomenon before. How do you know when your position is wrong? When time and price prove you wrong. For example, you sell the gap up opening and the market goes dead. Or you sell the gap up opening and time passes and it doesn't break. The market won't gap up and

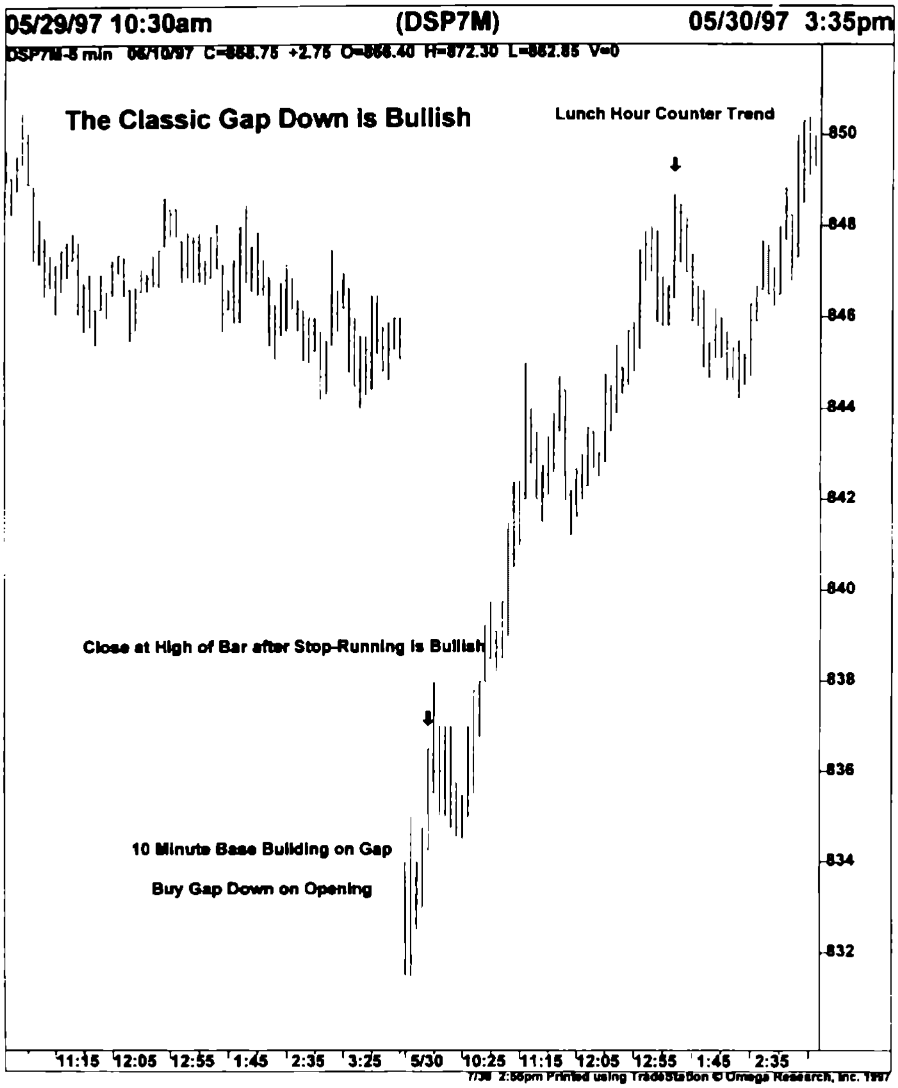


Chart #6: The classic gap-down opening must be bought. If the market cannot rally into the gap, there is something wrong. The close at the top of the 5-minute bar after stop-running is the sign of price rejection. The noon hour is often characterized by counter-trend price movement.

make a minor move. The more time passes with little price action, the stronger the ensuing move will prove to be.

I remember one morning when the S&P gapped higher and I immediately sold five contracts. You don't want to hesitate in such a situation, because the locals routinely sell such openings; typically, the gap is filled within ten, maybe fifteen, minutes. So having sold the open in anticipation of a good 100 to 125 point profit on the move back down to yesterday's closing value area, imagine my concern when the market was still churning sideways after fifteen minutes? The position was only marginally unprofitable at that point. But that wasn't the problem. Sensing something was wrong, I grabbed the phone and covered my short positions at the market. And not a moment too soon. Within minutes, the market was trading 200 higher!

Granted, this was an exception. The point is, you have to know how the market "should" behave if you are going to capture these anomalies.

THE ZONE CONCEPT

Successful trading is nothing more than a combination of understanding the probabilities and wedding your market activities to what W.D. Gann used to call "nerve," or courage. A successful analysis of the market is useless unless you can pick up the phone and take the trade. Since courage is an impossible quality to provide to a fearful trader, let's concentrate on the other component — understanding the probabili-

ties. Put simply, if you are trading a winning system, the probabilities favor you if you take the trades. The only 100 percent real guarantee you can have with any system is that if you do not take the signals, and refrain from trading entirely, you will have neither profits nor losses, a break even situation. The other side of the coin is if you are trading an unproven, or losing system. In this instance, you may indeed have profits initially, but, traded long enough, losses are inevitable. This, after all, is why casinos make money. Although there are indeed short-term winners playing casino games, the percentages favor the casino.

In the futures markets, the probabilities, far from being fixed against you, can be manipulated in your favor. How do you accomplish this manipulation? By understanding the probabilities, of which the zone concept is only one. Let me provide you with a simple example. In selecting a market to trade, I am taking into account the probabilities. Like everyone, my goal in trading is to make money. But I have to factor into the equation both the amount of risk I am going to sustain plus the equity necessary to achieve my goal. I may think, for instance, that there is a lot of money to be made building the world's tallest skyscraper. But this would take billions of dollars to accomplish — and, frankly, I don't think I could raise the money. So that idea, while perhaps suitable for Donald Trump, is out of the realm of possibilities. On the other hand, I might be looking at my brokerage firm's schedule of margins and notice that I can control an oats contract for just a few hundred dollars. But upon further inspection, I find that oats only has a four-cent range on the day and that I

have to pay commissions plus whatever edge the floor will take in allowing me to enter and exit the market. On top of that, of course, I have to be correct about the direction that prices will move. The probabilities don't favor that either.

So what works?

Finding a market where the risk-to-reward ratio is favorable. While there are not many such markets, there are enough to capture my interest. The S&P 500, the U.S. Treasury bonds, and the currencies, among others, all fit the bill. So selecting the market is the first decision you must make in getting the probabilities to work for you. There are many more decisions you can make that will likewise influence your odds of winning. In addition to market selection, there is the time of day you trade (the morning or afternoon trends), the strategy you use (day trading versus overnight position trading), the amount of equity you bring to the game (well-financed versus trading on razor-thin margins) — all these things can impact the probabilities in your favor. But the most important is utilizing the right strategy in the correct market.

As we've just discussed, when prices get out-of-line, there is apt to be a reaction — either a pullback in the opposite direction, or, more significantly, yet a further trend in the same direction. We've mentioned the turnaround number concept, in which having trended in one direction and turned around, the market becomes poised for another push. The zone concept is a variation of this principle. Once the market trades to, say, level A, the probabilities are no longer 50-50 that the market will rise or fall. Rather, having traded to Level A, the probabilities rise to as high as 70 to 80 percent that they will

now trade at Level B.

What is the drawback to utilizing this zone approach? Frankly, the trader must exercise patience. By refusing to select the appropriate spots to trade the market, the typical trader wastes his equity getting ground up by trading random movements. Then, when the real opportunities occur, he is nursing his losses and misses the legitimate moves. The fact is, the best trades occur with relative infrequency. Unless you are prepared to await these opportunities when the legitimate trends occur, you are likely to fall victim to the losses which are experienced by upwards of 85 to 90 percent of all futures traders.

The LSS approach is to project specific trading numbers within the key zones — both above and below the market. This, however, is the very opposite of trying to forecast the market. On the contrary, we are merely saying "if" and "when" the market reaches such a level, the probabilities favor it moving to yet another level, typically with the close as our exit target. Nevertheless, some users are clearly puzzled. "Why does the system generate up to five trading signals daily if none of them are hit?," they ask. The point is, we aren't trying to forecast anything. We are merely telling you that if Level A is hit, the probabilities favor the market then trading at Level B prior to the close. And, significantly, if Level A isn't reached, chances are a trade isn't warranted.

This is the sensible way to trade. Although it totally contradicts the conventional wisdom which suggests that some guru actually knows where the market is going. You could say that the more certainty with which a projection is made,

the less accurate the forecast is likely to be. This notion, that someone actually knows where the market is going, is fostered by the people who stand to profit from disseminating this information — with the help of a gullible public. This fundamental misconceived notion that an "expert" has the answers is one of the most costly mistakes one can make. The good news, of course, is that you don't have to know where the market is going; you only have to know how to trade. Knowing the probabilities associated with the zone concept can help you on this score.

I've discussed this notion of preferring the "action" to the money with many traders. And they all swear they are sincerely interested in making money. The typical call goes something like this:

"George, I'm ready for a good trading system. Nothing seems to work for me. How about LSS?"

"Fine," I say. "But you'll have to do exactly what the system tells you."

"No problem."

"Are you sure you want to make money?" I ask. "Or do you simply like the action?"

They always swear they want to make money. Yet they are the first ones to call me and say they aren't getting enough trades. You can trade fifty times a day, I suppose. Floor scalpers make hundreds of trades a day. Try it for yourself. But I bet you won't make any money. If you want to make money in the futures market, you must use a disciplined approach with winning probabilities.

TRADING THE SYSTEM

Whether you are trading LSS or another system, you are going to be surprised by the results unless you follow the rules. Having said that, let me say that no two people ever trade a 100-percent mechanical trading system in the same way. As a result, the comments about a system, such as LSS, will range the gamut of opinions from excellent to abysmal. So much depends on when someone begins trading the system and his attitude toward risk. When I first started selling LSS, a trader called me up and purchased the system. But he couldn't wait a day for us to send the software via overnight mail. Could we fax him the trades? We did. He caught a big winning coffee trade and paid for the system before it arrived. More often, however, the buyer is considerably more adverse to risk. He wants to "paper trade" the system for a while. So he starts paper-trading the signals and, sure enough, he observes (but doesn't trade) a big winning streak. You know the rest. Then he commits money to the market and the first five or six trades are losers and he's convinced he's made a big mistake. Although LSS has an acceptably high winning percentage, I once had a user who managed to only take the losing trades and not one winner. Why? His first two trades were losers and he jumped to the sidelines. Then he watched — but didn't trade — the next six consecutive winners. Determined to win, he then jumped back in the market and promptly lost on the next three trades. Then he stopped and it won on four consecutive trades. You get the picture. To his credit, he didn't blame me for his problems. The system,

after all, was a sound winner.

Here's what I tell anyone who wants to trade a system: wait until the system goes into a losing streak before taking the first trade. Chances are, since all systems experience winning and losing cycles, you will start out with a winner. I can't tell you how important it is to begin on a psychologically winning note. I firmly believe that every system must be "road tested" with real money before you offer it to the public. One time I took $50,000 just to see what I could do with it. The first trade was a winner and I now had $51,000 and change. The next trade took the account to $53,000 and we went all the way to $58,000 before the losing cycle hit. It backed off to $54,000 on the drawdown. But that was the low of the move. I ran the $50,000 account all the way to $120,000 before it sustained the first serious drawdown of approximately $8,000. But, hey, not bad for a test. In just a couple of months, I'd never gone into my initial equity for a minute.

Getting off on the right foot, however, requires a certain understanding of how systems work. Because the market experiences high-volatility and low-volatility days, you cannot expect to make the same amount of money daily — nor, for that matter, would you want to. I say this because if you "settle" for a fixed profit per day, you are doing the exact opposite of what you should be doing in the market — namely, limiting your losses and letting your profits ride. But, you say, if I can make several hundred dollars a day, I'm happy. Maybe so. But first show me someone who, day in and day out, can make steady profits. On some days, you are going to

lose. Now, you have to make up that day's loss as well as your steady profits if you are to maintain the winning streak. Occasionally, like all of us, you are going to make a mistake — or miss a day. Believe me, that will cost money. Understanding this, you should look for the big profits when they become available.

The fact is, **most systems make most of their money on comparatively few days.** For example, in the past two weeks in LSS, we made almost $4,000 on one-lots. This is about average for the system which returns just under $8,000 per month in net profits. This is an average return over time, with some months returning almost double that figure and other months only marginally profitable. In reviewing the past two week record, however, the system made 22 trades to net out approximately $4,000. Twelve of these trades resulted in profits, nine in losses, and one was a breakeven trade. In reviewing nine days of trading (no trade occurred on one day), however, just three trades accounted for the entire two-week profit. This translates into 14 percent of the trades accounting for 100 percent of the profit. Had you missed these three trades (two of them occurred on the same day), you would have had much different results.

In sizing up a system, you want to pay particular attention to maximum drawdown and **average** win per trade as well as average loss per trade, and the all-important net profit expected each time you take a trade. The average **drawdown** figure tells you what to expect in a worst case scenario. That is, if you started trading at an equity high, how much money would you have been out at the bottom at the equity low? In

the recent period I am examining, the amount is $1,132. But, significantly, the next trade was a winner. This was offset by a loser followed by a winner — a virtual standoff. Then the system made over $2,700 on two trades and you had your one-half monthly winning average. I don't need to stress how important it is have these winning trades to maintain a real-time performance comparable to the winning paper record.

The average win-to-lose ratio should be approximately two-to-one or better. This means that the typical winning trade should return approximately twice as much money as you lose on a losing trade. This is the ratio that LSS maintains. Lastly, the **average per trade** result is the amount of money, on average, that you stand to make, win or lose, every time you take a signal. With LSS, this number is about $175. This is the amount of money you should be making on average for every trade.

The longer the numbers are consistent or improving, the better the system. With LSS, we maintain a comprehensive computer record going back to 1987 and updated every week with the latest results. For serious purchasers of the system, we are happy to provide an up-to-date results disk free of charge. To receive a disk, call or fax the LSS software support line at:

(714)731-3384 voice • (714)669-8473 fax

MONEY MANAGEMENT

The traditional manner of testing a futures software program is to test the system against back data using one-lots. In LSS, we refer to this as a "unit." Thus, the system will say to buy or sell one unit at a specific price. If you are a one-lot trader, your unit number is one; is you are a six-lot trader, your unit is six, and so on. Because the system makes multiple entries in the same direction, however, you must be prepared to take as many as three units -- one at each of three different prices. Indeed, the days when the system adds another unit tend to be the most profitable.

In trading LSS — or any other system, for that matter — you must start with a unit number that you are prepared to stay with for some time. Typically, the size of the unit each trader selects is based on his equity level. New traders, who can occasionally be under-financed, tend to want to put up the minimum margin. But this is a serious mistake. The market is hard enough to beat without worrying about whether you have sufficient margin. How much margin does it require to trade LSS? Typically, you should have a minimum of $7,500 and perhaps as much as $13,000 if you want to trade one-lots. The S&P 500 and coffee require the most margin. But they are also the two futures that provide the greatest returns. So the risk is commensurate with the reward. Once your equity is above $20,000, you can think about multiple positions at each unit. As a general rule, you probably want to have about $10,000 in starting equity for each one-lot per unit.

The mistake that most traders make is that they increase the number of contracts too quickly. I am reminded of a client I had who starting trading seven lots in the S&P only to encounter a losing streak. After five or six losses with seven S&P contracts (that's $175 per tick), he had no choice but to cut the number of contracts. So he started trading one lots.

Frankly, I don't think even the best trading system could provide a strong enough performance to undo the damage of losing on seven lots if you are trying to make up the ground with one lots. The rule is, you have to take at least an equal number of contracts — and hopefully more — when you begin winning to offset the losses. If you have a win-to-lose ratio of two-to-one, even halving the number of contracts would just get you even on a system that won fifty percent of the time. So start with a position you can live with. And don't cut the number of contracts just because your equity curve has turned down.

There are ways to greatly enhance your results by using good money management with a winning system. But make sure the system is a winner before you engage in any complicated money management strategies. With LSS, we know that the coffee market is an outstanding performer — despite the drawbacks on slippage on the fills and a relatively illiquid market compared with, say, the bonds or S&P. One money management approach is to specialize in this one market. The problem for most traders, however, comes with the infrequency of the trades. You could literally spend days awaiting a signal.

Another fine-tuning approach is to pinpoint the trading

levels which are most productive (we have plenty of up-to-date statistics we can provide you with on this score), and concentrate on perhaps taking more contracts when those trades appear. For example, our "Level 4a" trades have maintained a 75 percent winning percentage whereas our "Level 2" trades are averaging under 50 percent. Armed with similar statistics, you should be able to create a money management strategy tailor-made to your own risk temperament.

THE NOTION OF THE ANTICIPATED RANGE

Serious students of LSS cycle theory pay particular attention to the anticipated range. Not to be confused with the average range, which is simply the ten-day average of prices, the anticipated range is the end calculation of the numbers crunching — the likely range for tomorrow's market. The LSS software graphically plots this range side-by-side with the daily actual ranges. Indeed, the anticipated range is perhaps the most accurate of all LSS calculations. While the LSS software is designed to do the work of endless hours of trivial calculations, some users prefer to use this information to make intra-day price projections as the day progresses. The difference between the buy and sell numbers (themselves the result of a myriad of additions and subtractions), the anticipated range provides the user a valuable tool for pinpointing daily highs and lows using intra-day highs and lows. By taking the intra-day high or low and subtracting or adding the anticipated range, one is often able to extrapolate a projected

high or low on the day which proves to be accurate. The theory behind this is quite simple. If, on average, you tend to have a range of, say, 500 points, and today's current range is, say, 300 points — then the probabilities favor an extension of the range by about another 200 points.

The classic manner in identifying the three-day cycle is to take ten days of open, high, low and close data and then pinpoint the lowest low and then count forward in the three-day pattern — buy, sell, short sell, and so on. But what do you do when the lowest low is taken out by a still lower low? Or when the market refuses to conform to a predetermined scenario — perhaps even behaving in a perverse reverse pattern? The answer is you have to rephase the cycle. At best, even when you perform the most rigorous market analysis, there may be confusing cross-currents in the market which confound your thinking. The simplest method of dealing with this situation is to simply push the cycle ahead a day. Accordingly, if you suspect the market will open lower tomorrow, lose ground until it finds support and then trend higher (the classic buy-day pattern), and it doesn't, chances are you were premature in your thinking. Push the cycle ahead by one day. It may occur tomorrow.

This can be a frustrating experience, but it is the only intelligent alternative to blindly taking a trade because you think the cycle day "must" occur. The purpose of rephasing is to help you find the correct three-day cycle. It is also important to remember that there's no rule to buy on a so-called Buy Long Day (L) or sell short on a Short Sell (SS) day. The designation of each day is simply to help you identify the pattern.

Often, the cycle will remain the same despite rephasing. For instance, you might have a low that occurred seven or eight days ago, and that designation may have changed several times since then. Each time, you go back and rephase the cycle. In each instance, the lowest low remains the same and the cycle stays intact. In time, however, a new, lower low will be established and the change will indeed take place. When this occurs, you base tomorrow's anticipated cycle day on the new rephased day. Let's say, for example, that before rephasing, today was designated as a Short Sale Day (SS); after rephasing, following today's close, however, today's (SS) day becomes an (L) day, or Buy Long Day. Hence, tomorrow's anticipated cycle day is the following day in the cycle - namely, the (S) day, or Sell Day.

THE TREND MOMENTUM INDICATOR

In order to understand rephasing, you must understand the Trend Momentum Indicator and the role it plays in the rephasing process. This indicator measures the rate at which the market is rising or falling. The indicator tends to lead the market, but it is not used to pinpoint buying or selling opportunities. When a market rallies, it moves up slowly at first, picks up speed, and then, although still rising, the momentum begins to slow, suggesting that a change in direction is imminent. Each time the trend momentum indicator changes direction, the cycle is rephased. Rephasing involves going back ten days and taking the lowest low as the new Buy Long

Day (L) and then counting ahead, Sell Day (S), Short Sell Day (SS), and so on. For users of the LSS software, this rephasing is automatic and the day is clearly identified after rephasing by hitting the "F5" key and the L, S, or SS designation is clearly shown under the daily price chart bar.

LSS analysts who prefer to do the calculation by hand will find the math simple to master. The rule is: take **today's** close and subtract the close **two day's previous.** Thus: close on day 3 – close on day 1 = trend momentum indicator number. The number generated is then compared to the two previous trend momentum numbers. The last number will then have one of the three patterns in terms of the previous two as follows:

1. Trend Momentum Indicator number more positive than two previous Trend Momentum Indicator numbers = **up trend**

2. Trend Momentum Indicator number more positive than one of the previous two numbers but more negative than the other number = **sideways trend**

3. Trend Momentum Indicator number more negative than two previous Trend Momentum Indicator numbers = **down trend**

THE BUY AND SELL ENVELOPES

As a rule, it is exceedingly difficult to forecast tomorrow's high and low in advance of the opening. Computer studies have shown that one can occasionally approximate these areas, but, in general, this attempt at forecasting in advance of knowing the "tone" of the market as characterized, for example, by the opening price is an exercise in futility. What can be accomplished, however, with a high degree of accuracy is the identification of trading zones within which support and resistance should occur.

I refer readers to my earlier book, Winning in the Futures Market, (Dow-Jones Irwin), for a more comprehensive discussion of the trading envelopes. In general, however, the components of the respective buy and sell envelopes are as follows:

The Buy Envelope is an area where support should be found in tomorrow's market.

Decline is how far a sell-off carried before support was found. Because the market can change over time, LSS averages recent decline numbers subtracted from the previous day's high, to give a ball park figure on where the support will be found.

Buy Under is the average of recent Buying Under numbers subtracted from the previous day's low.

Previous Low is the low of the day just finished. Lows are significant because they identify points in the market where the sellers couldn't push prices lower without buyers willingly taking everything the sellers wanted to sell.

Buy Pivot is a number that represents support (see Trend Reaction formula).

The Buy Number is the average of the four numbers in the buy envelope and the low of the next day's price projection (note: this number is subject to change given an out-of-line open).

<u>The Sell Envelope</u>, the mirror image of the buying envelope, is an area where resistance should be found in tomorrow's market.

Rally is the average of the recent rally numbers added to the previous day's low; the average of the Rally numbers signifies a resistance area where selling should overcome buying.

Buy High is the average of the recent Buy High numbers added to the previous day's high.

Previous High is the high of the day just finished. Highs are significant because they identify points in the market where the buyers couldn't push prices higher without sellers willingly offering comparable quantities that the buy-

ers wanted to buy. Thus, in calculating tomorrow's sell envelope, you take the most recent high as the point where resistance will be encountered. This concept is borrowed from Taylor, who maintained that resistance will always exist at the previous day's high.

Sell Pivot is a number that represents resistance (see Trend Reaction formula).

The Sell Number is the average of the four numbers in the sell envelope and the high of the next day's price projection (note: this number is subject to change given an out-of-line open).

The next day's **price projection** is the end result of the envelopes. The next day's projected high is the sell number generated by the sell envelope. The next day's projected low is the buy number generated by the buy envelope. The difference between the two is the anticipated range. It is important, however, to realize that this is simply the underlying structure upon which the LSS numbers are based. The actual trading signals are based on a much more sophisticated analysis of a series of market conditions, including an understanding of the overbought/oversold indicator, momentum, the phase of the cycle, and so on.

CALCULATING THE BUY AND SELL ENVELOPES

The four key measurements for determining support and resistance are easy to calculate once you understand the definitions and how to use them in creating the envelopes. The key measurements are:

- **Rally — today's high minus the prior day's low**
- **Decline — prior day's high minus today's low**
- **Buying High — today's high minus prior day's high**
- **Buying Low — prior day's low minus today's low**

These four measurements are easy to calculate. For purposes of illustration, however, assume the following:

Prior Day			**Today**		
Open	=	**847.60**	**Open**	=	**851.95**
High	=	**854.60**	**High**	=	**862.80**
Low	=	**842.75**	**Low**	=	**846.65**
Close	=	**849.30**	**Close**	=	**847.05**

Based on the above numbers, the calculations would be as follows:

Rally = 862.80 (today's high) – 842.75 (prior day's low) = 20.05

Decline = 854.60 (prior day's high) – 846.65 (today's low) = 7.95

Buying High = 862.80 (today's high) – 854.60 (prior day's high) = 8.20

Buying Under = 846.65 (today's low) – 842.75 (prior day's low) = 3.90

These four numbers will generate two support level prices for the buy envelope and two resistance level prices for the sell envelope. The Rally and Buying High numbers are used to calculate the resistance numbers that go in the Sell Envelope. The Decline and the Buying Low numbers are used to calculate the support numbers that go in the Buy Envelope.

To calculate how these numbers are established using just these two days, you must do the following:

1. **Add the Rally (R) Number to today's low**

2. **Add the Buying High (BH) Number to today's high**

3. **Subtract the Decline (D) Number from today's high**

4. **Subtract the Buying Low (BL) Number from today's low**

Therefore, to calculate tomorrow's numbers:

1. 20.05 (R) + 846.65 (today's low) = 866.70 **Rally Number**

2. 8.20 (BH) + 862.80 (today's high) = 871.00 **Buying High Number**

3. 862.80 (today's high) – 7.95 (D) = 854.85 **Decline Number**

4. 846.65 (today's low) – 3.90 (BL) = 842.75 **Buying Low Number**

In terms of the envelopes, the four numbers would appear as follows:

Sell Envelope:	871.00
	866.70
Buy Envelope:	854.85
	842.75

Now, to add a wrinkle to the calculations, these numbers would be fine if we only had one day to measure. However, we **average the rallies and declines and buying highs and buying lows of the last three trading days.** Thus, if the last three rally figures were as follows, the average would be derived by adding the three entries and dividing by three. For example:

Rally 1 - 7.35

Rally 2 = 7.95

Rally 3 = 20.05

Average = 35.35 divided by 3 = 11.80

This is the amount that the market tended to rally during the past three days. We now add this number to today's low to get the legitimate averaged rally number for tomorrow:

11.80 (Averaged Rally) + 846.65 (Today's Low) = 858.45

This averaging of three days is then done for the Decline, the Buying High, and the Buying Low. The final calculations will find their way into the Buy and Sell Envelopes for tomorrow.

TODAY'S HIGH AND LOW

Two more numbers that pinpoint support and resistance are today's high and low. These signify resistance and support respectively. They should be factored into the envelopes as well. Now, we have three support numbers and three resistance numbers. You would be surprised how often the market will trade to one of these numbers and perhaps penetrate one number slightly and then retreat. I call this tendency to go to a price and change direction "price rejection." Always be aware of where the high and low occurred on any

given day. Chances are, on the following day, that number will be significant.

MULTIPLE ENTRIES

LSS, which stands for "long," "sell," "short sell," is designed for a potential of three entries during the trading day. This notion of having multiple entries allows the user of the system to trade aggressively by averaging down or up. On any given day, therefore, all or none of the orders may be entered. The idea of multiple entries goes to the heart of the system, which is based on support and resistance.

Because LSS tries, essentially, to successfully position the trade during a single trading session, the entry levels must be placed at strategic points within the buy or sell envelopes. These support and resistance levels are determined by recent market action, specifically volatility. Accordingly, in highly volatile markets (markets in which big profits are available), the size of the envelopes will be larger than in other markets. This also means that the stop-placement must be farther away from the entry prices than would otherwise be the case in less volatile markets.

The notion behind this concept of multiple entries is that there are different price levels where the market should find support and resistance. If these areas cannot hold, the market will find its way to another area. As we've already mentioned, the market tends to trade in zones of its own creation. Once inside one of these zones, buyers and sellers become com-

fortable entering and exiting the market. This creates stable — and predictable— buy and sell envelopes.

With LSS, we are attempting to find these important price levels and use them for entering and exiting the market. The notion of multiple entries allows us to aggressively trade where recent historical price history tells us are relatively safe areas for placing positions. The means we are often "fading" the trend at the time the order is placed.

THE OVERBOUGHT/OVERSOLD OSCILLATOR

In March 1996, we introduced a completely new version of the LSS software that significantly improved the results of the system. Among the new improvements was the introduction of an oscillator that helps keeps the user on the right side of the market. The oscillator is based on the traditional overbought/oversold indicator. Very similar to the Stochastic %D calculation, the oscillator calculates the overbought/oversold indicator in the previous fashion and then, after ten days, creates a **10-day average** of the previous overbought/oversold numbers.

To begin, here's the traditional formula for the overbought/oversold indicator:

$$\frac{(\text{High - Open}) + (\text{Close - Low})}{2 \text{ X Range}} = \text{overbought/oversold indicator percentage}$$

Here are the prices for the September S&P 500 contract on August 9, 1996:

Open	=	666.20
High	=	668.20
Low	=	661.40
Close	=	662.45

Now, using our formula, here's how that day's overbought/ oversold percentage is calculated:

$$\frac{(668.20 - 666.10) + (662.45 - 661.40)}{2 \text{ X } (668.20 - 661.40)}$$

$$= \frac{2.10 + 1.05}{2 \times 6.80} = \frac{3.15}{13.60} = 23.16\%$$

Accordingly, this is the reading that is generated at the end of trading on August 9, 1996.

Once you have accumulated ten days of data and daily overbought/oversold readings, you can then average the readings. Thus, after ten days of readings, you can calculate a 10-day moving average by simply adding the last 10 daily numbers and dividing by 10.

In the following table, I've listed the Daily Overbought/ Oversold Percentages for 13 trading days. On day 10, the first 10-day average is calculated. After you have accumulated ten days of data, you are ready to begin the moving average calculations:

DAY	DAILY 0VBT/OVSLD	10-DAY 0VBT/0VSLD
1	23.16	—
2	99.69	—
3	33.29	—
4	28.50	
5	53.41	—
6	14.01	—
7	67.66	—
8	87.33	—
9	72.60	—
10	80.71	56.04
11	28.19	56.54
12	57.51	52.32
13	63.58	55.35

USING THE OSCILLATOR TO PINPOINT DIRECTION

There are three key considerations in creating an oscillator to help you determine market direction. They are:

* **The market you are trading**

* **The number of days to average the overbought/oversold indicator**

* **The number of days the market has rallied or declined**

As with most good market indicators, the oscillator calculation must take into account the above factors. The oscillator that you use on one market will not be appropriate to another market. The reason for this is markets have different patterns. Currencies tend to do better with a longer oscillator, because they trend so well. Whereas a more choppy market, such as the S&P 500, does better with a shorter oscillator. Markets tend to have cycles which are unique to those markets. For example, the S&P 500 tends to have a well-known 11-day cycle between making a top and a bottom. Other markets will differ in their cycle duration.

As a rule, you need to combine these factors and make intelligent judgments concerning the market. For example, if the market has been rallying for five or six days and you have a high reading on the moving average oscillator (90 percent or higher), chances are you are near the top day in the cycle. The same is true as you approach bottoms, of course. If the market has declined for five or six days and the oscillator is posting a reading of under 15 percent, chances are you are getting near the bottom. When the market is not at an extreme, readings above 50 percent tend to be bullish whereas readings below 50 percent tend to be bearish. The oscillator can keep you on the right side of the market during these trending periods.

THE INTRA-DAY 3-STEP CYCLE

By concentrating on intra-day price movements, we can

begin to identify the same buy, sell, sell-short pattern that is so evident in the 3-day cycle. Typically, all three cycles will be present on a given day — although, significantly, not necessarily beginning with the buy day pattern. For example, the market may open at the high of the day (the high made first) and then trade significantly lower into the noon hour. This is the short-sell pattern (high made first, low made last). Next, during the counter-trend noon hour, the market may trade slightly higher or sideways. Beginning with the afternoon trade, you may have the low made first (the buy-day pattern) with a rally into the close. By isolating market segments, you will begin to see the same patterns emerging. Let's spell out the three steps in the cycle:

* Buy pattern — low made first followed by higher prices

* Sell pattern — follow through on higher prices with top near previous cycle high

* Sell-short pattern — high made first followed by lower prices

The 3-step intra-day-cycle might appear to be about as difficult to identify as the 3-day cycle. A trader has to identify a pattern early in its creation — often a challenging task. But with study, I suspect you'll grow familiar with this crucial identification process.

Perhaps the best way to prove to yourself that this pattern

exists is to study five-minute bar charts. What to look for? The same thing the 3-day cycle analyst studies — the LSS pattern. This means you look for an opening price that is counter to the trend. For instance, after a lower open, you have lower prices followed by a significant rally. From beginning to end, you may be talking about 45 minutes from low to high — there's the "L" pattern. Next, consolidation followed typically by a shot at the highs (running the stops?). Finally, an afternoon rally that fails and the market retreats back toward the lows. In a nutshell, there you have the complete cycle!

Here are some notes I recently made while observing this precise 3-step pattern. First, there was the timing — the first move occurred right after the open, early in the day. Second, the market is "engineered" lower — a sign that the "true" direction is ultimately up. Third, I observe price "rejection" at the bottom one-minute bar — the close of the bar is at the high. The market never looks back. Fourth, the market moves about 200 points in 30 minutes, demonstrating that it wants to get somewhere in a hurry. Fifth, there is a double-bar identical close, a sign of price stabilization — and often signalling the 50 percent equilibrium level. (Based on this 50 percent rule, the market later misses the projected high by a couple of ticks.) Sixth, having exhausted itself at the top, the market goes sideways for about an hour prior to plummeting — the classical short sell signal!

On yet another day, I observe the same phenomenon: up, sideways, down. Once again, the patterns, which Taylor observed 40 years ago, occur like clockwork — up in the morn-

ing, sideways during the lunch hour, and down in the afternoon. There are many, many similar chart patterns. As a would-be successful day trader, it is your job to take this information and do the research to convince yourself that this pattern exists. Only then will you have the confidence to pick up the phone and place winning trades.

SUMMARY

LSS is based on the notion that time and price will form a coherent pattern with support and resistance. While LSS, which owes its genesis to the well-known "Book Method" of George Douglass Taylor, was originally designed as strictly a day-trading method, the principles apply whether you are interested in trading the long-term or on an intra-day basis. The fact is, the three-day pattern of buy, sell, and sell-short repeats endlessly. Significantly, extensive computer testing on a variety of markets clearly demonstrates that not only does this pattern exist, but that a viable trading strategy can be created to capitalize on the market's tendency to trade in this pattern. For additional information on LSS, you can study one of my previous books in which I write about the three-day phenomenon. They are Winning in the Futures Market (Dow-Jones Irwin) and How to Triple Your Money Every Year With Stock Index Futures (Windsor Books). The new LSS software, which runs on DOS, is now available and runs on nine futures contracts. For a free demonstration disk, contact:

Investment Software Systems, Inc.
1742 Amherst Rd.
Tustin, CA 92680
(714)731-3384 voice
(714)669-8473 fax

Here are some points to remember on LSS:

* **A three-day pattern exists in the market, and often this three-day pattern appears as a three-step pattern on an intra-day basis.**

* **When you can identify this pattern, you will find that the market is taken lower to go up (buy), rallies and stabilizes (sell), and is often taken higher one last time (sell short) prior to declining.**

* **The pattern has the effect of driving out the weak hands (stops) by the strong hand (stop runners).**

* **The entries can be mutually exclusive or can result in averaging, depending on the volatility of the market.**

* **Clear-cut support and resistance zones are identified by measuring recent rallies and declines.**

* **A new oscillator based on a daily overbought/oversold sentiment indicator is useful in keeping you on the right side of the market when you trade LSS.**

* **If you study the "anticipated" ranges versus the "actual" ranges, you will see how accurate these LSS measurements can be.**

* **The average range measurement can be used to forecast daily highs and lows by utilizing the intra-day high and low.**

* **You trade at a disadvantage if you are unaware of the LSS cycle pattern.**

SEVEN

Putting It All Together — Day-Trading With Precision

Mastering the art of precision day-trading requires a disciplined approach to your trading activities. Since it is impossible to ever have one-hundred percent certainty in your trading judgments, you must settle for second-best — namely, putting the probabilities in your favor. As you have seen from the numerous strategies outlined in this manual, there are a number of time and price studies which, when performed "on-the-fly," allow you to fine-tune your trading to a degree which was impossible for the off-the-floor trader before the advent of the new computer technology. The new technology, however, is nothing more than a valuable tool. You must still be able to analyze the data which is now available to you and act on your judgments. When wedded to a sound knowledge of support and resistance theory, time and price analysis provides you with a number of measurable markets to determine whether a given trade is on target or not.

Where to begin in sizing up a precision day trade? First and foremost, you must give up on the notion of certainty. No one ever really "knows" for certain what will happen in

the market. Once you make this leap of faith, so to speak, you will free yourself to make reasoned judgments based on sound probabilities. Ironically, by embracing the uncertainty of a situation, you enable yourself to make so-called "intelligent" judgments simply because the odds favor one scenario over another. In looking back over the pages that proceed this chapter, I suspect this is the best observation one can make — one never knows for certain, but the odds favor certain probabilities. The good news inherent in this notion is that you don't have to know where the market is going. But you do have to know how to trade. So the basic rules must be observed or you are doomed to failure. What are the basics? Keep your losses small and let the profits ride. Don't over-trade. Use discipline. Expect the unexpected. Have a trading plan. And so on.

A TRADING CHECKLIST

The plan is very simple — to make money. How to accomplish that goal? In a nutshell, the strategy is to look for two trends a day — one in the morning, one in the afternoon. The trends can be broken down into two distinct legs, both measurable in terms of time and price, and the legs are separated by a profit-taking sideways action which generates a so-called "equilibrium" price. If you miss the first leg (which you often will since there is so little to work with prior to the first leg completing itself), you can often capitalize on the second leg. If you miss a morning trade it is perhaps best if

you wait until the afternoon trade presents itself. You cannot turn a trendless market into a trending one. Yet rare is the day when some trend doesn't present itself.

The best trades, as we've observed again and again in these pages, often occur amidst the most uncertainty. The sure-things never seem to work out. But by embracing the uncertainty (with probabilities favoring your strategy), you can often emerge victorious — if you know what you are doing. The so-called opening counter-trend, for instance, is so commonplace that you can often obtain an excellent fill by "fading" the opening gap. The rule is the market will often trade into the gap and frequently (perhaps 75% of the time) at the previous day's closing price. This particular strategy, however, will not always work. But when it doesn't you also know what to do — reverse quickly. Again, the notion is simple. The market which cannot rise, will decline — and vice versa. Why do these ideas appear so easy and straightforward? Because they are. Yet successful, precision day-trading is exceedingly difficult. Nevertheless, the challenge is to correctly monitor a number of often conflicting indicators and continue to make sound judgments at the same time. If I'm currently in a trade, do I stay, run, reverse — or take more? Moreover, these questions must be answered in a fluid situation. It is always easy to analyze the move after it is over. But trying to analyze a developing trade can be daunting. With an appreciation of the difficulty of sizing up a market in mind, let's now review some of the precision day-trading strategies.

1. The Opening Gap Trade. Gaps can be characterized as so-called "normal" or "extreme" gaps. The normal gap is often created by a continuation of a previous day's closing pattern or a running of the stops. This gap can often be "faded" (traded against) at least until the gap is closed or the previous close is reached. You will have gaps on one-minute charts that don't appear on five-minute charts because they are sometimes filled so rapidly. The floor locals love to fade these opening gaps. So-called "extreme" gaps, on the other hand, are often created by news-driven events. They suggest the market wants to get somewhere in a hurry and are best traded in the direction of the initial opening — buy the up gap, sell the down gap. Once the gap is filled, however, remember it is then a whole new ball game.

2. Reversal Strategies. When the market is about to trend and you find yourself on the wrong side, you need to reverse sides — quickly! Mastering this art is not easy, but it can prove very profitable. A variation on the reversal strategy is the "double-and-reverse" strategy which has you taking twice as many contracts on the reversal trade. This means you only need a move of one-half the initial loss to break even on the two trades. This strategy is difficult to implement but often wins the game.

3. The Extreme End Of The Range Occurs In The First Hour And The Final Hour. This is an underrated piece of information which can help you successfully position a day trade. If, for instance, you are an early-morning buyer

and the probabilities favor the low already being made on the day, your order can be executed with low risk. The same, of course, is true with selling against highs. The statistical studies can also help you anticipate a move to new high or low ground as the final hour develops. You can then use complementary time and price studies to "fine-tune" the timing of the trade.

4. The .618 Retracement Trade. Whenever you have an initial trend, you can measure the range and multiply the result by .618. You then subtract this number from the high when you are buying or add this amount to the low when selling. Often, this .618 measurement provides an excellent spot to place a low-risk trade since, in the event the .618 entry point is violated, you can exit quickly if you are wrong.

5. Divergent Indicators. The more indicators you track, the more likely you will find divergence between one or more of them. Rising prices and a plummeting premium, for instance, is one such divergence. Many traders look for a divergence, at reversal points, between prices and the slow stochastics. Typically, at tops, you will have an initial surge in the stochastics reading over 80% followed by a rally that fails to penetrate the previous high. This failure swing creates a divergence when the futures prices continue into new high ground on the second rally. At bottoms, the pattern is reversed. You have an initial decline down between 30% on the stochastics. Then, on a subsequent decline, the reading fails to penetrate the previous low. Meanwhile the second

decline in prices falls under the previous low, creating the divergence. The market is then poised to rally.

6. Fade the Running of the Stops. If you are already in a position, often the best place to exit is when the stops are run. Where are the stops typically found? Just above intra- or inter-day highs and just below intra-or inter-day lows. Traders place stop-loss orders at these points because they think it is safe to do so. In fact, these stops are truly "easy pickings" for the knowledgeable insiders who know they can buy and sell at these advantageous lows and highs.

7. Beware of "Market Engineering." According to Taylor's theory, the market is often taken down prior to going up. The flip side: it is taken up prior to going down. Be aware of this pattern and fade morning countermoves.

8. Learn to Distinguish a "Short-covering" Rally from the Real Thing. A short-covering rally must be sold. A genuine rally must be bought. The first, which is characterized by a brief flurry of buy orders driving prices quickly higher, often creates a spike up and goes dead at the top. The open and close of the one-minute bar in such a rally is frequently at the bottom of the bar. This is further evidence that the move is over. Short-covering rallies are panicked affairs which begin — and end — quickly. The genuine rally, on the other hand, is slow to develop. All the sales are met with strong bids and the closes are progressively higher.

9. Perform the Time and Price Calculations. Prices move in terms of time and price. So much time must pass before prices can move a given magnitude. Sometimes, however, market symmetry will work in terms of price and not time — and vice versa. At other times, both time and price will have perfect symmetry. Prices tend to move in two distinctive legs, separated by an equilibrium phase. So you will have, for instance, a 500-point rally followed by a sideways equilibrium (profit-taking) phase followed by another 500-point rally. It is significant to understand that once this second leg is over, the move is completed! At least in terms of the morning or afternoon. Add in the time calculations and you have comparable legs as well. If, for example, it takes 24 minutes for the first rally (measured low to high), then the second leg will often have the very same time duration.

There are wrinkles on this theory, however. The second leg may speed up by a factor of two — i.e. 24-minutes up on the first rally followed by just 12-minutes on the second rally. Or the entire morning trend may have taken two hours to complete the range on the day followed by a comparable extension of the range later in the afternoon which required one-half the time or just one hour. Once again, it is important that you recognize when the move is over. Holding on beyond that point is often counter-productive since profit-taking will only diminish your profits.

10. Time Your Trades. You don't enter the market to have it go dead on you. At the outside, you are looking for profits to develop within 30 minutes and often within ten

minutes. If the trade isn't working relatively soon after you enter, you need to rethink your strategy. Occasionally, you may have the correct side selected but you were premature in your entry. You can then use market adversity to add to your position, averaging either up or down depending on the initial position. The advantage of this averaging technique is that the second entry can be accomplished with relatively little risk. If this second entry isn't profitable almost immediately, you need to exit the entire position and rethink your strategy. You may be on the wrong side. Typically, time will tell you whether you are right or wrong.

11. Only Take A Trade To Capture The Morning Or Afternoon Trend. You don't want to trade during the noon hour when the market is apt to be trendless. Rather, try to capture the morning or afternoon trend. Occasionally, you will have a trending day when the morning entry can be held to the close. But this is the exception. The other exception occurs when there is no morning trend. Then the first trend may be pushed into the noon hour. Yet, the general rule is that there will be a trend developing in the very first hour, shortly after the open and in the final hour of the trading session. Looking for more than two genuine trends a day is a mistake that often leads to over-trading.

12. Don't Play Someone Else's Game. You cannot be a scalper off the floor. Don't become a "tick-hound" and think you can grab three or four ticks by buying the bid and selling the offer. Floor traders can play this game because they don't

pay commissions and they have the added advantage of immediacy. And even they regret scalping when the market trends. You need to play a game where the probabilities give you a winning edge.

13. Be Aware Of The "Paradoxical Event." Markets are often misleading. Look for the hidden clues in price behavior. Chances are, the majority of traders are apt to become suddenly surprised when a market reverses direction. The "herd instinct" predominates in the market, yet "contrary opinion" typically wins the day.

14. Don't Get Caught On A "Search And Destroy" Day. Markets that won't trend can be a serious problem for the day trader. If you make four or five attempts to find the right side without success, chances are you are better off quitting for the day. Otherwise, you can easily parlay a $500 loss into a $10,000 loss. On average, you'll experience a gyrating trendless day about once a month.

15. Map Out Several Different Scenarios Before You Take A Trade. Unless you know what to expect, you won't be quick enough to run when you are wrong. For this reason, you must know when and where you'll be in trouble. In addition, you want the market to achieve certain objectives without specific time constraints. For example, you might be willing to buy the March S&P 500 within a 90-to-100 point buying zone. But if it falls below that zone, you must exit quickly. In addition, you may want to give the market 20 to

25 minutes to prove profitable — if not sooner. Remember, if the market cannot go up, it will probably decline. While you can intelligently increase the odds in your favor, you can never have certainty in the market.

16. Know The "Report Days." Because you don't want to be blind-sided by a surprise report, make it your business (your broker can help you on this) to know when the reports are being released. Even reports that are expected can cause the market to gyrate suddenly. Employment rates, housing starts, and comments by the Fed chairman have been known to roil the markets. Another thing to keep in mind when you anticipate a report is how the market tends to behave on the day preceding the report. Typically, this is a bad day to trade because the Street is unwilling to commit to one side or the other in anticipation of the report. Hence, you have a lot of meaningless gyrations and stop-running. Rare is the day before a report when the market trends well.

17. Know The LSS Day-Pattern And The Market's Current Trend. This should be common sense. If the market has recently broken out and is running to new high ground day after day, it is one thing. If it is in a trading range, you need to adjust your market strategy. In general, the market spends little time going from level to level. And then it spends a comparatively lot of time churning within the support and resistance of the trading range. The 3-day cycle is valuable in providing you with a clue on what tomorrow's price action will bring — and how to capitalize on that trend.